TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, 1960

No. 288

AMERICAN AUTOMOBILE ASSOCIATION,
PETITIONER,

vs.

UNITED STATES.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

PETITION FOR CERTIORARI FILED AUGUST 2, 1960

CERTIORARI GRANTED OCTOBER 10, 1960

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1960

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[fol. 1]

IN THE UNITED STATES COURT OF CLAIMS

Docket No. 311-58

AMERICAN AUTOMOBILE ASSOCIATION, Plaintiff,

v.

UNITED STATES OF AMERICA, Defendant.

PETITION—Filed July 8, 1958

Plaintiff brings this action to recover from the United States of America the sum of $207,994.56 with interest according to law, representing Federal income taxes and interest collected illegally by the defendant from the plaintiff for the calendar years 1952 and 1953, and in support of its action alleges as follows:

(1) Plaintiff is a corporation with principal office at 1712 G Street, Northwest, Washington, D. C. Plaintiff was incorporated in the year 1910 under the laws of the State of Connecticut, and was organized and is operated as a non-profit, non-stock, membership corporation.

(2) Plaintiff is a national organization which renders services to affiliated local automobile clubs and their mem-
[fol. 2] bers and performs services of a public nature in fields relating to motoring and travel.

(3) In addition to the activities described in paragraph (2) above, plaintiff operates directly, as divisions, the following local automobile clubs:

District of Columbia Division of AAA (Metropolitan area, Washington, D. C.)
Louisiana Division of AAA (entire state)
Massachusetts Division of AAA (part of state)
New Hampshire Division of AAA (entire state)
New Mexico Division of AAA (entire state)

North Florida Division of AAA }
South Florida Division of AAA } (part of state)
Texas Division of AAA (part of state)
Wisconsin Division of AAA (entire state)
Wyoming Division of AAA (entire state)

(4) A substantial portion of the annual gross income of plaintiff is derived from dues, prepaid for one year in advance, received from members of the automobile clubs described in paragraph (3) and operated as divisions of plaintiff. Plaintiff is obligated to provide services for such members over the twelve-month period following payment of dues, which services include emergency road service, travel information, accident insurance, bail bond, and similar items.

(5) Plaintiff, commencing with the calendar year 1943, has been required to file Federal income tax returns and to pay Federal income taxes on its net income. Its Federal income tax returns are filed with the District Director of Internal Revenue, Baltimore, Maryland. The plaintiff's taxable year is the calendar year.

(6) Plaintiff employs the accrual method of accounting in keeping its books and records and in filing its Federal income tax returns.

(7) Under the method of accounting employed by plaintiff throughout the years in issue dues prepaid for one year [fol. 3] in advance by a member of an automobile club operated as a division of the AAA were reflected in plaintiff's income ratably over the twelve-month period of the membership covered by the dues rather than entirely in the calendar year in which the dues were received. That portion of the prepaid dues of a member not reflected in income in the year of receipt was credited to an account called "Deferred Revenue—Membership Dues" and reflected in income during the following calendar year. Similarly, prepaid commission expenses and prepaid accident insurance costs paid by plaintiff in behalf of a member of its divisions were not deducted from income entirely in the calendar year paid or incurred but were spread ratably over the

twelve-month period of the membership. That portion of prepaid commissions and prepaid accident insurance costs not deducted from income in the year paid or incurred was charged to an account called "Prepaid Membership Costs" and deducted from income during the following calendar year.

(8) The method of accounting employed by plaintiff as described in (7) above, was adopted upon the advice of qualified members of the accounting profession many years prior to 1943, when plaintiff was first required to pay Federal income taxes. This method of accounting has been regularly used by plaintiff, was accepted by the Commissioner of Internal Revenue for the calendar years 1943 through 1952, and is in conformity with the provisions of sections 41 and 42(a) of the Internal Revenue Code of 1939 and sections 446(a), 446(c)(2) and 451 of the Internal Revenue Code of 1954.

(9) The method of accounting employed by plaintiff in keeping its books and records and in filing its Federal income tax returns clearly reflects its net income or loss for a calendar year.

(10) The net income of plaintiff for the calendar year 1952 computed in accordance with the method of account-[fol. 4] ing employed in keeping its books and records and prior to the net operating loss carryback deduction from 1954, was $154,411.11.

(11) The net income of plaintiff for the calendar year 1953 computed in accordance with the method of accounting employed by plaintiff in keeping its books and records and prior to the net operating loss carryback deduction from 1954, was $353,279.09.

(12) During the calendar year 1954 plaintiff sustained a net operating loss of $289,967.67, computed in accordance with the method of accounting employed by plaintiff in keeping its books and records. Under section 172 of the Internal Revenue Code of 1954 plaintiff is entitled to a net operating loss carryback deduction from the calendar year 1954 to the calendar year 1952 in the amount of $154,411.11;

and a net operating loss carryback deduction from the calendar year 1954 to the calendar year 1953 in the amount of $135,556.56. The net operating loss carryback deduction from 1954 eliminates all 1952 taxable income, and reduces the plaintiff's 1953 taxable income from $353,279.09 to $217,722.53.

(13) Upon audit of its tax returns for the calendar years 1952, 1953 and 1954, the Commissioner of Internal Revenue reduced the 1954 operating loss of plaintiff from $289,967.67 to $14,412.49. This reduced the net operating loss carryback deduction from 1954 to 1952 to $14,412.49 and eliminated any net operating loss carryback deduction to 1953. In addition, the Commissioner increased the net income of plaintiff for 1953 by $128,278.50.

(14) The reduction in the amount of the net operating loss sustained by plaintiff during the calendar year 1954 and the increase in the net income of plaintiff for the calendar year 1953 as determined by the Commissioner were caused by the fact that the Commissioner forced plaintiff to change its method of accounting as described [fol. 5] in paragraph (7) of this petition, so as to report all prepaid dues as taxable income in the calendar year of receipt, whether or not earned in that year, and so as to deduct all prepaid membership expenses in the calendar year paid, irrespective of whether such expenses were properly allocable to that year under the accounting method regularly used by plaintiff.

(15) The action of the Commissioner of Internal Revenue in changing plaintiff's method of accounting as described above, was without authority and in error.

(16) As the result of the adjustments described heretofore, the Commissioner of Internal Revenue on May 15, 1956 asserted an income tax deficiency against plaintiff in the amount of $58,083.58 for the calendar year 1952 and in the amount of $137,907.48 for the calendar year 1953.

(17) On May 23, 1956 plaintiff paid to the District Director of Internal Revenue, Baltimore, Maryland, additional 1952 income taxes in the amount of $58,083.58 plus

interest thereon in the amount of $2,019.37, and additional 1953 income taxes in the amount of $137,907.48 plus interest thereon in the amount of $10,789.77.

(18) On May 9, 1958 plaintiff filed with the District Director of Internal Revenue, Baltimore, Maryland, a claim for refund of income taxes and interest for the calendar year 1952 in the amount of $60,102.95 and for the calendar year 1953 in the amount of $147,891.61, based upon the four grounds described hereinafter:

First, that plaintiff's method of accounting clearly reflected its net income or loss, that the Commissioner's method of accounting did not, and that the Commissioner had no power or authority to force plaintiff to change from an accurate to an inaccurate method of accounting as described heretofore.

Second, plaintiff's method of accounting was designed to match the income derived from a member of its divisions [fol. 6] with the expense of serving such member in order to determine whether a profit was derived from a membership. If the prorata allocation of prepaid dues on a monthly basis over the period of a membership should be held to be artificial or held not to reflect income clearly, plaintiff claimed in the alternate the refunds to which it was entitled based upon a method of accounting which spreads dues over the twelve-month period of a membership in proportion to the average cost per month of serving a member determined by reference to the experience of plaintiff during the five preceding years. On such basis the 1954 operating loss would be $282,782.12, the 1953 net income before the carryback deduction would be $358,993.93, and the income tax refunds to which plaintiff was entitled would be $58,083.58 for 1952 and $130,486.03 for 1953 together with interest according to law.

Third, the imposition of an income tax computed in the manner forced upon plaintiff by the Commissioner during the years in issue was unconstitutional because an income tax was in effect being imposed upon gross income rather than net income.

Fourth, the method of accounting forced upon plaintiff by the Commissioner during the years in issue did not clearly reflect its net income or loss. Plaintiff is entitled to have its net income or loss and its Federal income tax liability during such years recomputed by reference to any method of accounting which does clearly reflect its net income or loss.

(19) The Commissioner of Internal Revenue disallowed said claims for refund on the 1st day of July, 1958.

(20) The Commissioner of Internal Revenue erred in failing to approve said claims for refund on each and all of the four grounds described above.

(21) No action on this claim other than that described heretofore has been taken by plaintiff before the Congress [fol. 7] of the United States or before any department of the government.

(22) Plaintiff is and always has been the sole and absolute owner of the claims described herein and no transfer or assignment of said claims or any part thereof has been made by plaintiff.

Wherefore, plaintiff prays for judgment against the United States of America in the amount of $207,994.56 together with interest thereon according to law.

Fleming Bomar, Attorney for Plaintiff.

Ivins, Phillips & Barker, 306 Southern Building, Washington 5, D. C.

[fol. 8]

IN THE UNITED STATES COURT OF CLAIMS

[Title omitted]

ANSWER—Filed September 5, 1958

The defendant, United States of America, by its attorney, Charles K. Rice, Assistant Attorney General, answering the allegations in plaintiff's petition herein:

I

Defendant denies the allegations contained in the introductory paragraph, except that defendant admits that in this action plaintiff seeks to recover from the United States of America the sum of $207,994.56.

II

Further answering the petition, defendant—

1. Admits the allegations of Paragraph 1, except that defendant denies that plaintiff is a non-profit corporation.

2. Admits the allegations of Paragraph 2.

[fol. 9] 3. Admits the allegations of Paragraph 3.

4. Admits the allegations of Paragraph 4.

5. Admits the allegations of Paragraph 5.

6. Admits the allegations of Paragraph 6.

7. Admits the allegations of Paragraph 7.

8. Denies the allegations of Paragraph 8, except that defendant admits that the method of accounting referred to therein was regularly used by plaintiff.

9. Denies the allegations of Paragraph 9.

10. Denies the allegations of Paragraph 10, except that defendant admits that the net income reported by plaintiff in its income tax return for the calendar year 1952 com-

puted in accordance with its method of accounting was $152,975.31.

11. Denies the allegations of Paragraph 11, except that defendant admits that the net income reported by plaintiff in its income tax return for the calendar year 1953 computed in accordance with its method of accounting was $352,125.84.

12. Denies the allegations of Paragraph 12.

13. Denies the allegations of Paragraph 13, except that defendant admits that upon audit of plaintiff's returns for the calendar years 1952, 1953 and 1954, the Commissioner of Internal Revenue reduced the 1954 operating loss claimed by plaintiff in the amount of $290,186.04 to $14,412.49 and that this reduction in the net operating loss claimed eliminated any net operating loss carryback to 1953. Defendant further admits that in addition, the Commissioner increased the net income of plaintiff for 1953 by $128,278.50.

14. Denies the allegations of Paragraph 14, except that defendant admits that the reduction in the amount of the net operating loss claimed by plaintiff for the year 1954 [fol. 10] and the increase in the net income of plaintiff for the calendar year 1953 as determined by the Commissioner were caused by the fact that the Commissioner changed plaintiff's method of accounting as described in Paragraph 7 of this petition so as to include all prepaid dues as taxable income in the calendar year of receipt. Defendant further admits that the Commissioner allowed as deductions from plaintiff's taxable income as reported, all membership expenses in the calendar year in which paid.

15. Denies the allegations of Paragraph 15.

16. Admits the allegations of Paragraph 16.

17. Admits the allegations of Paragraph 17, except that defendant denies that the payments referred to therein were made on May 23, 1956 and alleges that the payment of additional taxes and interest for the year 1952 was made on May 28, 1956, and that the payment of addi-

tional taxes and interest for the year 1953 was made on May 25, 1956.

18. Denies the allegations of Paragraph 18, except that defendant admits that on May 10, 1958, plaintiff filed with the District Director of Internal Revenue, Baltimore, Maryland, claims for refund of income taxes and interest for the calendar year 1952 in the amount of $60,102.95 and for the calendar year 1953 in the amount of $147,891.61. Defendant further admits that such claims were based, in addition to others, on the four grounds set forth in Paragraph 18 but defendant denies all allegations set forth in such grounds and all other substantive allegations contained in such claims for refund unless otherwise herein specifically admitted.

19. Admits the allegations in Paragraph 19.

20. Denies the allegations in Paragraph 20.

[fol. 11] 21. Denies the allegations of Paragraph 21 for lack of information sufficient to form a belief as to the truth thereof.

22. Denies the allegations of Paragraph 22 for lack of information sufficient to form a belief as to the truth thereof.

Wherefore, defendant, having fully answered plaintiff's petition, prays that it take nothing in this suit; that plaintiff's petition be dismissed, and that defendant be allowed its cost herein.

Charles K. Rice, Assistant Attorney General.

William T. Kane, Attorney.

[fol. 12]

IN THE UNITED STATES COURT OF CLAIMS

No. 311-58

[Title omitted]

REPORT OF COMMISSIONER—Filed July 16, 1959

To the Honorable the Chief Judge and Associate Judges of the United States Court of Claims:

Pursuant to the order of reference in the above-entitled case, the undersigned Commissioner makes the following report of his findings of fact:

1. Plaintiff is a corporation with its principal office at 1712 G Street, Northwest, Washington, D.C. Plaintiff was incorporated in the year 1910 under the laws of the State of Connecticut and was organized and is operated as a non-stock, membership corporation.

2. Plaintiff is a national organization which renders services to affiliated local automobile clubs and their members and performs services of a public nature in fields relating to motoring and travel.

3. In addition to the activities described in paragraph two above, plaintiff operates directly, as divisions, the following local automobile clubs:

District of Columbia Division of AAA
(Metropolitan area, Washington, D. C.)
Louisiana Division of AAA (entire state)
Massachusetts Division of AAA (part of state)
New Hampshire Division of AAA (entire state)
New Mexico Division of AAA (entire state)
North Florida Division of AAA } (part of state)
South Florida Division of AAA }
Texas Division of AAA (part of state)
Wisconsin Division of AAA (entire state)
Wyoming Division of AAA (entire state)

[fol. 13] 4. A substantial portion of the annual gross income of plaintiff is derived from dues, prepaid for one year in advance, received from members of the automobile clubs described in paragraph three and operated as divisions of plaintiff. Plaintiff is obligated to provide services for such members over the 12-month period following payment of dues. The services provided by plaintiff for the members of its divisions during the years in issue, although tending to be parallel, were not completely uniform and included the following: (a) A complete travel service which included trip planning, tour books, accommodation directories, maps and recommended routes. (b) Emergency road service which consisted of towing, changing tires, replacing batteries and other minor repairs. The road service was provided by plaintiff through contracts made with garages and service stations in the areas served by its divisions. (c) Bail bond protection up to $5,000 through contracts made by the plaintiff with bondsmen. (d) Personal automobile accident insurance which included hospitalization, personal injury and death benefits on a sliding scale in the event of a motoring accident. The plaintiff contracted for the insurance on a group basis and paid the premiums on the group policies. (e) A theft reward offered by the plaintiff for information leading to the arrest and conviction of any person stealing a member's car. In addition, the plaintiff, in one or more of its divisions, provided other personal services for members which included procuring motor licenses, notarial services, brake and headlight adjustments, and advice on how to prepare and file papers in small claims courts.

5. In order to make available and provide for the members of its divisions the services which plaintiff contracted to provide, plaintiff during the years in issue owned or rented offices in 39 to 41 different geographical locations and had on its divisions' payroll 495 employees in December 1953 and 603 employees in December 1954.

6. Plaintiff, commencing with the calendar year 1943, has been required to file Federal income tax returns and to pay Federal income taxes on its net income. Its Federal income tax returns are filed with the District Director of

Internal Revenue, Baltimore, Maryland. The plaintiff's taxable year is the calendar year.

[fol. 14] 7. Plaintiff employs the accrual method of accounting in keeping its books and records and in filing its Federal income tax returns.

8. Plaintiff, within the time prescribed by law, filed Federal income tax returns with the District Director of Internal Revenue, Baltimore, Maryland, for the calendar years 1952, 1953 and 1954. The 1952 return reported a net income of $152,975.51, the 1953 return reported a net income of $352,125.84, and the 1954 return reported a net operating loss in the amount of $290,186.04.

9. Upon audit of plaintiff's Federal income tax returns for the calendar years 1952, 1953 and 1954, the Commissioner of Internal Revenue made several minor adjustments which are not in issue in this proceeding, the net effect of which was to increase plaintiff's 1952 net income to $154,411.11, to increase plaintiff's 1953 net income to $353,279.09, and to reduce plaintiff's 1954 net operating loss to $289,967.67.

10. Plaintiff claimed that as a result of its 1954 net operating loss in the amount of $289,967.67, it was entitled to a net operating loss carryback deduction to 1952 in the amount of $154,411.11, and a net operating loss carryback deduction to 1953 in the amount of $135,556.56.

11. Upon audit of plaintiff's Federal income tax returns for the calendar years 1952, 1953 and 1954, the Commissioner of Internal Revenue also determined not to recognize the method of accounting employed by plaintiff in computing its income derived from prepaid dues collected from members of its divisions during the calendar years 1953 and 1954, which is the issue in this proceeding. The net effect of such determination was to increase plaintiff's 1953 net income from $353,279.09 to $481,557.59 and to reduce plaintiff's 1954 net operating loss from $289,967.67 to $14,412.49, with the further result that the Commissioner reduced plaintiff's net operating loss carryback deduction

from $154,411.11 in 1954 to $14,412.49 in 1952 and eliminated entirely any net operating loss carryback deduction from 1954 to 1953.

12. The Commissioner of Internal Revenue determined the increase of plaintiff's income for 1953 by $128,278.50 [fol. 15] and the reduction of plaintiff's loss for 1954 by $275,555.15 was in the following manner:

	1953 Adjustments	1954 Adjustments
Reserve for unearned and deferred income Dec. 31 of current year	$1,756,485.46	$2,039,264.43
Less reserve for unearned and deferred income Dec. 31 of prior year	1,562,042.23	1,756,485.46
Difference	194,443.23	282,778.97
Less		
Prepaid commissions:		
Dec. 31 of current year	398,482.36	405,706.15
Dec. 31 of prior year	332,317.63	398,482.36
Difference	66,164.73	7,223.79
Net additional income determined for the current year	128,278.50	275,555.18

All of the foregoing items are reflected in the plaintiff's balance sheets as of December 31 for the years involved, which were filed with its income tax returns for 1953 and 1954. The liabilities contain the account UNEARNED AND DEFERRED INCOME, and the assets contain the account PREPAID COMMISSIONS, but the latter account is not involved in the items labeled prepaid commissions in the above tabulation. The deduction items employed by the Commissioner of the Internal Revenue Service represent plaintiff's asset account for prepaid membership costs. The plaintiff's assets for 1954 do not reflect any amount for prepaid membership

costs, but its liabilities for unearned and deferred income reflect the approximate net difference between $2,039,264.43 and $405,706.15 in its 1954 balance sheet..

13. As a result of the adjustments described heretofore, the Commissioner of Internal Revenue on May 15, 1956, asserted an income tax deficiency against plaintiff in the amount of $58,083.58 for the calendar year 1952, and in the amount of $137,907.48 for the calendar year 1953. These deficiencies in tax, plus interest of $2,019.37 for the year 1952 and $10,789.77 for the year 1953, were paid by plaintiff on May 25, 1956, and May 28, 1956.

[fol. 16] 14. On May 10, 1958, plaintiff filed timely claims for refund for each of the years in suit, which claims for refund raised the issues upon which plaintiff now seeks recovery in this action. On July 1, 1958, the Commissioner of Internal Revenue notified plaintiff by registered letter that its claims for refund had been denied.

15. Plaintiff, being a nonstock, membership corporation, obtained substantially all of the funds necessary to carry on the operation of its divisions by advances from its members, i.e., dues prepaid for one year in advance in consideration of services to be rendered by plaintiff over the ensuing 12-month period.

Plaintiff's balance sheets filed with its 1953 and 1954 income tax returns reflect cash on hand December 31, 1953, of $1,941,723.88 and dues paid in advance of $1,756,485.46. The excess of $185,238.42 would represent cash received from other sources. However, on December 31, 1954, the dues collected in advance and reported in plaintiff's balance sheet at $1,634,840.81 exceeded the cash on hand of $1,502,478.97 by the sum of $132,361.84.

16. Under the method of accounting employed by plaintiff during the years in issue, advance dues collected from members of its divisions were not regarded entirely as income for accounting purposes in the calendar year of receipt, but instead advance dues were recognized and treated as income ratably over the 12-month period during which plaintiff was obligated to render services to such

members whether or not such period extended beyond the close of plaintiff's taxable year.

As of December 31 of each taxable year, the proportion of advance dues, collected within the year applicable to membership contracts extending beyond the close of the taxable year and for which services had not yet been rendered or made available, was considered and recorded as a liability of plaintiff and was reflected on plaintiff's balance sheet with its tax return as a liability.

Expenses which plaintiff considered to fall within the category of prepaid membership costs, i.e., salesmen's commissions, and the cost of accident insurance covering the period of a membership, even though paid by plaintiff, were [fol. 17] not deducted entirely in the taxable year paid or incurred, but instead were deducted ratably over the same periods of time that advance dues were recognized as income.

17. During the calendar years 1953 and 1954, plaintiff recorded on its books and records, by months, the following amounts of prepaid or advance dues collected from members of its divisions:

	1953	1954
January	$257,698.02	$290,764.23
February	236,610.67	284,319.95
March	282,430.08	351,697.47
April	296,647.02	329,066.99
May	328,191.75	382,385.38
June	378,716.30	451,260.81
July	386,150.87	435,832.93
August	336,269.66	395,009.70
September	275,235.54	260,950.54
October	268,661.48	309,543.51
November	219,278.02	279,144.44
December	265,289.26	308,553.22
	3,531,178.67	4,078,529.17

This money was deposited in plaintiff's bank accounts with no restrictions as to its use for any of its corporate

purposes. It was, in fact, prepaid financing by the members for the corporation's operating funds, including the cost of services to be performed during the following 12-month period of membership, as reported in finding 15 herein.

Section 4 of the bylaws of the American Automobile Association specifically provided for the use of funds and reads as follows:

> SECTION 4. (*Use of Funds*) This corporation shall use its funds only to accomplish the objects and purposes specified in Section 3, and no part of said funds shall inure, or be distributed, to the members of this corporation. On dissolution the funds of the corporation shall be distributed to one or more regularly organized charitable organizations to be selected by the Board of Directors.

18. Prepaid dues were true liabilities of the plaintiff at the time they were collected. Under the accounting system employed by the plaintiff from 1931 through 1953 advance dues collected from members who joined in the month of [fol. 18] January were recognized as income in January to the extent of 1/24 of such collections, on the assumption that the average or mean date would be the middle of the month. Thereafter, 1/12 of prepaid collections for January was transferred or allocated to income for each of the following 11 months, and 1/24 of January collections remained a liability on December 31 and was transferred and recognized as income for January of the following year.

Prepaid dues for each month of the calendar year were treated in the same manner, that is, 1/24 of such collections was transferred and recognized as income in the current month when collections were made, 1/12 of such collections during the following 11 months and 1/24 thereof in the last month when membership expired. The monthly collections of prepaid dues during a calendar year which were recognized and transferred to income during the current year and the portion thereof remaining in the liability account at the end of the year, which was entitled DEFERRED REVENUE MEMBERSHIP DUES, UNEARNED AND DEFERRED INCOME OR some similar title, appear in the following tabulation:

	Portion Treated as Income for the Current Year	Portion Remaining in the Liability Account Dec. 31 and Treated as Income the Following Year
January	23/24	1/24
February	21/24	3/24
March	19/24	5/24
April	17/24	7/24
May	15/24	9/24
June	13/24	11/24
July	11/24	13/24
August	9/24	15/24
September	7/24	17/24
October	5/24	19/24
November	3/24	21/24
December	1/24	23/24

The allocation of prepaid dues each month facilitated the preparation of monthly statements of income and expenses. Had monthly collections been equal for each month during a year, the amount recognized as income during the current year and the amount remaining as a liability at the end of the year would have been equal under the foregoing apportionments.

[fol. 19] 19. Under the method of accounting employed by plaintiff, the proportion existing between dues collected from members of its divisions within a calendar year, which dues were recognized as income during such year, and the proportion of such dues regarded as a liability at the end of such year was as follows for the calendar years 1949 through 1954:

	Portion Recognized as Income During the Year Collected	Portion Remaining in the Liability Account Dec. 31 and Treated as Income the Following Year
1949	49.9%	50.1%
1950	50.0%	50.0%
1951	50.2%	49.8%
1952	50.6%	49.4%
1953	50.3%	49.7%
1954	50.0%	50.0%

20. Commencing in 1954, in order to simplify much internal detail, the plaintiff changed its procedure in the monthly accounting for prepaid dues by the assignment of 50 percent to income for the current year and 50 percent as a liability which matured as income for the following year.

Plaintiff also adjusted certain inconsistencies in its prepaid expense account in 1954. Some division managers were paid a straight salary, whereas others were paid a nominal salary plus incentive commissions based upon the number of members within the division. These incentive commissions had been previously charged to the prepaid expense account and prorated over membership periods, whereas such incentive pay was actually a part of the manager's compensation. It was treated as current expense in 1954 and thereafter. Also, guaranteed commissions to new salesmen for a certain limited period had been included with commissions earned on subscriptions obtained, as prepaid expense, and beginning in 1954 such unearned guaranteed payments were charged to current expenses.

The plaintiff continued the apportionment of prepaid dues collected and prepaid expenses for commissions and insurance over the period of membership as it had done previously. The basic method of accounting employed by plaintiff in 1954 was consistent with that employed by plaintiff in 1953 and prior years.

[fol. 20] 21. The income reported by plaintiff in its tax return for the calendar year 1953 attributable to dues received from members of its divisions was $3,337,813.44, representing $1,562,042.23 of prepaid dues collected in 1952 but not recognized as income until 1953, plus $1,775,771.21 of dues collected in 1953 and recognized as income in that year.

For 1954, dues reported by plaintiff as income for purposes of the Federal income tax totaled $3,794,672.20, representing $1,755,407.46 of advance dues collected in 1953 but not recognized as income until 1954, plus $2,039,264.74 of dues collected in 1954 and recognized as income in that year.

22. The method of accounting employed by plaintiff during the years in issue has been used regularly by plaintiff since 1931 and was used both before and after plaintiff was required to pay Federal income taxes. The method of

accounting employed by plaintiff during the years in issue is in accord with generally accepted accounting principles and practices and is customarily and generally employed in the motor club field.

The Internal Revenue Service did not question the method of accounting employed by plaintiff in computing its net income until the calendar year 1954, at which time deficiencies were proposed for the calendar years 1950, 1951 and 1952, but plaintiff was not required to pay those deficiencies by reason of a compromise settlement.

23. Under generally accepted accounting principles a distinction is made between a financing transaction and a revenue or income transaction. Funds received in a revenue or income transaction are reflected in the profit and loss statement of a taxpayer as gross income. This is not true in the case of funds received in a financing transaction. They are reflected in the balance sheet as liabilities.

Financing transactions involve ways and means of raising funds for business operations and may be grouped under three general types: (a) funds obtained from shareholders in exchange for stock; (b) funds obtained from banks or other lenders on notes, bonds or other evidence of indebtedness; and (c) funds obtained by advances from customers or members on open accounts, receipts or certifi-
[fol. 21] cates of membership for future delivery of goods or services to be rendered in the future.

Funds representing advances from customers or members of an organization are not income at the time they are received but constitute a liability until such time as goods are delivered or services are rendered or made available in accordance with the advance payment agreement. It is an undisputed principle of accounting that no revenue or income can emerge until goods are delivered or until services are rendered.

Upon the prepayment of annual dues a member of the plaintiff corporation acquired a right to receive certain materials, information and services provided in the membership agreement over a 12-month period. Plaintiff's liability to such member cannot be completely discharged until the expiration of the membership period. Under generally accepted accounting principles, it is realistic and reason-

able to recognize and transfer to gross income such prepaid dues ratably over the period of membership.

24. The determination of additional income by the Commissioner of the Internal Revenue Service for the taxable years involved herein was made by including as income the advance payment of dues covering membership benefit periods in the following year and excluding those payments received in the prior year that covered membership benefit periods in the current year. This application of the receipt of funds as income is contrary to generally accepted accounting principles and practices.

By taking into income for the current year the plaintiff's liability for servicing membership periods in the following year, the amount of such receipts would be reflected in the plaintiff's surplus account at the end of the current year. The plaintiff's balance sheet as of December 31, 1953, filed with its tax returns for 1953 and 1954 reflecting the items involved, is compared with the balance sheet which would result from the adjustments by the Commissioner of the Internal Revenue Service in the following table:

[fol. 22]

	Balance Sheet on December 31, 1953	
	(a) Reported by Plaintiff	(b) Reflecting the Adjustments by the Commissioner of IRS
ASSETS:		
Cash	$1,941,723.88	$1,941,723.88
Prepaid membership cost	398,482.36	.....
Prepaid commissions	177,079.51	177,079.51
All other accounts, net	2,834,525.72	2,834,525.72
Total assets	5,351,811.47	4,953,329.11
LIABILITIES:		
Unearned and deferred income	1,756,485.46	.....
All other liabilities	1,063,462.99	1,063,462.99
Total liabilities	2,819,948.45	1,063,462.99
SURPLUS	2,531,863.02	3,889,866.12

The above statement (b), embodying the adjustments by the Commissioner of the Internal Revenue Service, reflects an overstatement of surplus for 1953 of $1,358,003.10, or approximately 54 percent in excess of the true surplus.

By applying similar adjustments to plaintiff's balance sheet as of December 31, 1954, the surplus would be increased and overstated by $1,634,840.81, or approximately 99 percent, and would omit plaintiff's liability to members for a similar amount.

A balance sheet as of any given date represents an inventory of cash and accounting evaluations of all other asset accounts and liability accounts of an individual or firm on the date designated, and is prepared for the purpose of reflecting the net worth and financial responsibility of such firm or individual.

The evidence establishes that reputable members of the accounting profession would not certify to the accuracy of the income statements and the balance sheets reflecting the adjustments by the Commissioner of the Internal Revenue Service.[1]

[fol. 23] 25. The defendant contends that the sole issue is whether the Commissioner of Internal Revenue erred in refusing to allow plaintiff to defer a portion of income actually received, without any restriction as to its use, from the year in which it was received to the following year when services might have to be performed under the membership contracts.

The advance payment on a service contract, or any other type of contract, does not constitute income or revenue to the recipient, although the acceptance thereof creates a lia-

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[1] Defendant offered no testimony. Plaintiff's testimony consisted of that of its staff auditors supplemented by outstanding certified public accountants testifying as experts who were, also, either familiar with plaintiff's problem or had some direct association with it and whose qualifications were not challenged. They were: *Dr. Wm. A. Paton*, for 44 years a professor of accounting and economics at the University of Michigan and an author and consultant on accounting. *George E. Baker*, Washington, D.C., resident partner of Ernst and Ernst, Certified Public Accountants. *Herbert T. McAuly*, a general and managing partner of Ernst and Ernst. *S. Alexander Bell*, partner in Peat, Marwick, Mitchell & Co., largest firm of Certified Public Accountants in the world.

bility to perform. Under generally accepted accounting principles, the accounting for the funds received in advance must be recorded as a liability of the recipient. The plaintiff did this consistently since 1931. These membership contracts entitled the members to receive membership services over a period of 12 months from the date of subscription and acceptance. The plaintiff's gross income from dues was measured by collections for the period memberships were in effect during the current year. This included pro rata amounts of prepaid dues collected in the prior year covering membership periods that extended into the current year, but excluded prepaid dues collected in the current year for membership periods that extended into the following year. The membership service costs and other operating expenses paid or incurred during the current year were then deducted from such gross income for its determination of net income.

The method of accounting employed by plaintiff was in accordance with accepted accounting principles. The assignment and transfer of funds from the prepaid dues account to revenue or gross income measured over the period of the membership contracts is found to be the most realistic method for properly recording gross income from dues.

26. The restriction of funds represented by prepaid dues was not required or intended by the plaintiff's members. On the contrary, the receipt of prepaid dues from members constituted the principal source of plaintiff's operating funds as heretofore found. Funds from other sources, such as sales of publications, materials and supplies, advertising, etc., were normally received only after the costs and expenses were incurred in producing such revenues.
[fol. 24] There is no evidence that membership contracts, or certificates issued by plaintiff to its members, provided any restriction in the use of funds received by plaintiff for dues paid in advance. Plaintiff's financial responsibility is not questioned.

27. The plaintiff prepared and submitted tabulations of the aggregate costs incurred by all of its divisions in servicing all members thereof for each month of each year

from 1948 through 1954. These tabulations were received as plaintiff's exhibits 2 through 7, inclusive.

Had the plaintiff recognized, assigned and transferred to its gross income account its monthly receipts of dues collected in advance in the proportion to its cost of servicing all of its members each month, instead of ratably over the membership period of 12 months, the proportion of advance dues which would have been recognized and assigned to gross income during the years in issue herein would have been substantially the same as the gross income from dues as determined and reported by the plaintiff under the method of accounting actually employed.

28. The proportions of prepaid dues transferred and assigned to gross income by the plaintiff on a pro rata monthly time basis are compared with the proportion of assignments under the average monthly cost bases for servicing memberships in the following table:

	Plaintiff's Pro Rata Method as Reported	Average Monthly Costs for Current Year	Average Monthly Costs over Prior 5-year Period
1953			
Apportioned to Gross Income during current year	50.3%	49.8%	50.4%
Deferred to the Following Year (reported as a liability at the end of the current year)	49.7%	50.2%	49.6%
1954			
Apportioned to Gross Income during the current year	50.0%	48.8%	51.0%
Deferred to the following year (reported as a liability at the end of the current year)	50.0%	51.2%	49.0%

29. The recognition, assignment and transfer of dues collected in advance to gross income on the basis of actual costs of servicing members is feasible under the accrual [fol. 25] method of accounting, particularly in testing the results of prorating such collections on a time basis. It is not as practicable as the assignment of prepaid dues on a pro rata monthly basis because the current costs incurred must first be determined. The employment of a prior year's monthly costs or a composite of monthly costs for five prior years might not be as accurate as the method actually employed by plaintiff because of a constant increase in membership reflected over the years or by abnormal costs of servicing members during one or more of such prior years.

When members paid their annual membership dues they became entitled to membership services over a period of 12 months, notwithstanding any variations in costs to the plaintiff in furnishing the services that might be required. When plaintiff accepted such dues it became obligated to perform the services to which members were entitled and might require over the membership period without regard to any variations or fluctuations in costs in furnishing such services from month to month over the membership period.

On the evidence presented, the recognition and assignment of prepaid dues ratably over the period of membership is found to be the most realistic and practical method of accounting for gross income from membership dues.

30. The plaintiff's membership for all divisions reflects a constant increase from month to month during 1953 and 1954. The minimum number of memberships in effect in 1953 was 220,435 in January and the maximum was 246,856 in December of that year. The minimum number of memberships in effect in 1954 was 249,805 in January and the maximum was 295,889 in December of that year. The average cost to plaintiff of servicing a member during the calendar year 1953 was $14.50 and the average cost for 1954 was $14.72.

31. The plaintiff's liability for servicing members whose membership continued beyond the current year when dues were paid was not a "contingent" liability. It was a true liability and the costs were substantially in proportion to

membership from year to year with reasonable constancy from month to month. The plaintiff's actual costs of ser- [fol. 26] vicing all members from 1948 to 1954 are set out in the following tabulation:

1948	$1,587,794.87
1949	1,698,144.27
1950	2,012,466.23
1951	2,614,396.96
1952	3,109,068.21
1953	3,377,389.91
1954	3,991,068.00

32. The actual average monthly cost per membership in effect during 1953 and 1954 and the percentage of the total annual cost per member is reported in the following tabulation, with the percentage of the total monthly costs to the total costs for the preceding five-year period:

	1953			1954		
	Average monthly cost per member		Percent of monthly costs to total over prior 5-year period	Average monthly cost per member		Percent of monthly costs to total over prior 5 year period
Month	Amount	Percent of cost for year		Amount	Percent of cost for year	
January	$1.12	7.71	7.48	$1.12	7.62	7.46
February	1.10	7.57	7.47	1.27	8.62	7.34
March	1.24	8.52	8.54	1.37	9.27	8.44
April	1.32	9.15	8.85	1.24	8.41	8.82
May	1.28	8.84	8.97	1.35	9.18	8.83
June	1.32	9.12	9.03	1.41	9.56	9.07
July	1.35	9.28	8.90	1.34	9.12	8.93
August	1.23	8.52	8.58	1.24	8.41	8.67
September	1.19	8.22	8.15	1.20	8.16	8.26
October	1.19	8.19	8.20	1.17	7.95	8.42
November	1.06	7.29	7.56	1.10	7.49	7.65
December	1.10	7.59	8.29	.91	6.21	8.11
Total	14.50	100.00	100.00	14.72	100.00	100.00

The foregoing tabulation reflects the actual average cost to plaintiff in each month of the years involved for each member whose membership continued in effect. The difference between the costs incurred for servicing member-

ships that continued from the prior year and the membership fees collected in the prior year, but remaining as a liability of the plaintiff at the end of the year and transferred to gross income in the current year, would represent the net income in the current year applicable to such memberships.

33. The plaintiff's liability to members for that portion of their memberships which extended beyond the current [fol. 27] year in which plaintiff collected the dues in advance is not gross income from membership dues because it was paid and received for a later year. Neither can it be net income in the year when the dues were received because the cost of servicing such memberships could not be performed until the following year when such net income would be realized.

The method of accounting employed by the plaintiff during the calendar years 1953 and 1954 and prior years in keeping its books and records clearly reflected its net income for such years. The plaintiff's income tax returns for 1953 and 1954 were prepared in accordance with the method of accounting employed in keeping its books and records and clearly reflected the net income for these years. This conclusion and the findings set forth above are supported by the overwhelming weight of the documentary evidence and expert testimony.

Respectfully submitted,

Marion T. Bennett, Commissioner.

[fol. 28]

Excerpts From Testimony Before Commissioner

AFTERNOON SESSION (1:30 o'clock p.m.)

Commissioner Bennett: Mr. Bomar.
Mr. Bomar: Professor Paton, please.

Whereupon—WILLIAM A. PATON, a witness produced on behalf of the Plaintiff, being first duly sworn by said Commissioner, was examined and testified as follows:

Direct examination.

By Mr. Bomar:

Q. Would you please state your name and address?
A. My name is William A. Paton. My address is 2203 Hill Street, Ann Arbor, Michigan.
Q. What is your occupation?
A. My major activity is college teaching.
Q. And what is your present position?
A. My present position is Edwin Francis Gay University Professor of Accounting, and also Professor of Economics at the University of Michigan.
Q. Professor, how long have you served on the faculty of the University of Michigan?
[fol. 29] A. With minor interruptions I have served there for 44 years.
Q. And when were you made a full professor?
A. In 1921.
Q. Please describe briefly your educational background.
A. My undergraduate college work was taken at Michigan State Normal College and the University of Michigan. I held three degrees from the University of Michigan, including the Ph.D. granted in 1917.
Q. What was the subject of your doctoral dissertation?
A. The topic of my dissertation was accounting theory with special reference to the corporate form of enterprise.
Q. Professor Paton, are you a Certified Public Accountant?

A. Yes, I am. I hold a certificate granted by the State of Michigan.

Q. Are you the author of any books, texts or treatises on the subject of accounting?

A. Yes, I am an author or co-author of 15 or 20 books and treatises. Perhaps the most important and best known among the textbooks are "Essentials of Accounting" first published in 1938, "Asset Accounting" published in 1952, and "Corporation Accounts and Statements" published in 1955. I might also mention that I was editor and the major contributor also to two editions of the Accountants Hand-[fol. 30] book.

Q. Are you at the present time serving in any capacity as a consultant for the United States Government?

A. Well, I have one small connection at the present time in that I am serving as a member of the Educator-Consultant Committee, it is called, of the General Accounting Office.

Q. And do you now or have you ever served as a member of any committee of the American Institute of Accountants?

A. Well, yes, I served between eleven and twelve years as a member of the Committee on Accounting Procedure of the American Institute of Accountants, now called the American Institute of Certified Public Accountants. That, I think, is my principal assignment in that Institute.

Q. Professor Paton, have you, at my request and at the request of other attorneys in cases where you have testified as an expert witness on the subject of accounting, prepared a written statement which describes your educational background, your teaching appointments, the books and articles which you have written, the professional societies of which you are a member, your professional and business experience and other activities which are relevant to your qualifications as an expert witness on the subject of accounting?

A. Yes, sir, I have.

Mr. Bomar: Your Honor, at this time I would like to [fol. 31] offer as Plaintiff's Exhibit No. 8 this statement of qualifications of Professor Paton, and I would like to have him recognized as an expert witness on the subject of accounting in this case.

Commissioner Bennett: Have you seen the memorandum, Mr. Kane?

Mr. Kane: No, but I am familiar with Professor Paton and I have no objection to this going in evidence, and I recognize Professor Paton as an expert in the accounting field.

Commissioner Bennett: The statement is received. The witness qualifies.

(Document containing data regarding training and experience of Prof. William A. Paton was marked Plaintiff's Exhibit No. 8 and received in evidence.)

By Mr. Bomar:

Q. Professor Paton, have you read the petition filed by the American Automobile Association in this case, Government's answer, the agreed stipulation of facts, and have you heard the testimony given by witnesses who preceded you in this case?

A. Yes, sir, I have read the petition and the answer and the stipulation and have heard the testimony that has been given up to date by the preceding witnesses.

Q. Are you familiar with the method of accounting em- [fol. 32] ployed by the American Automobile Association during the years in issue in accounting for dues received in advance from members of its divisions?

A. Yes, speaking rather generally, I would say that I am familiar with the method that has been employed by the Association.

Q. And are you familiar with the change in Plaintiff's method of accounting which the Commissioner of Internal Revenue seeks to force upon Plaintiff?

A. Yes, sir.

Q. Professor Paton, if the American Automobile Association is incorporated as a non-stock membership organization and finances its operations by means of dues prepaid for twelve months in advance by members of its divisions, and in return for such prepaid dues the American Automobile Association is obligated by contract or otherwise to render specified services to its members over the ensuing 12-month period following receipt of such dues, would it be

proper, in your opinion, under generally accepted accounting practices for the American Automobile Association to treat as revenue or income in the year of receipt the entire amount of such dues even though the Club is obligated to render services to its members for a period which extends beyond the close of the taxable year?

Mr. Kane: Your Honor, before answering that question, [fol. 33] I want to interpose an objection to Professor Paton's testimony as an expert in this case, on the basis that I consider this testimony to be given in the form of an advisory opinion to the Court and that the issue before this Court is a legal issue rather than an accounting issue, and that any answer that he will give here today will be an advisory opinion, which we take the position is not proper matter for expert testimony, no more than having a lawyer testify as to what the law should be.

Mr. Bomar: Your Honor, in determining whether expert testimony is admissible, my understanding of the law is that first we must determine whether the matter under inquiry is subject to opinion testimony from the point of view of whether the issue involves an area where expert testimony would be helpful.

In my opening statement I called attention to the fact that the taxpayer is required to compute net income in accordance with the method of accounting used in keeping its books and records unless such method does not clearly reflect income.

I also call your attention to the fact that the statute, both section 42 of the 1939 Code, and section 451 of the 1954 Code, requires that all items of gross income shall be included in the gross income for the taxable year when received by the taxpayer unless the methods of accounting [fol. 34] permitted such amounts to be properly accounted for as of a different period.

It seems to me that no matter what the witnesses who I propose to qualify as experts to testify in this case, it would have no bearing on the ultimate legal question to be resolved, whether tax law differs materially from generally accepted accounting principles.

Furthermore, there are numerous cases in which experts have been permitted to testify on the ultimate issue involved in the case, such as reasonableness of salaries. Experts are qualified in my view even when they testify on the sole issue in the case, such as valuation of property when that is the sole issue in a case.

I think that the issue involved in this case clearly is one in which expert members of the accounting profession are peculiarly qualified to render competent testimony.

Commissioner Bennett: The objection is overruled.

Mr. Kane: May I have an exception, and the same throughout the testimony of experts, an objection and exception?

Commissioner Bennett: You may.

Mr. Kane: Thank you, Your Honor.

The Witness: No. It would not be proper.

By Mr. Bomar:

Q. And why not?

[fol. 35] A. It would not be proper because the procedure that you described is in conflict with an absolutely basic principle of accounting, namely, that we must distinguish between a financing transaction and revenue or income transactions. I regard that as pretty close to the cornerstone of accounting.

Q. What do you mean by a financing transaction?

A. Briefly a financing transaction is a transaction in which funds are raised by any organization or enterprise to get it going and carry on its activities. There are three main ways of doing it. Speaking of corporations and organizations generally, substantial funds are raised from stockholders. Another source, a second major source is borrowing at the banks or from other lenders. Third and actually quite an important source is that of advances by members or customers.

Many companies would utilize primarily the first two sources, acquiring funds from stockholders or from creditors such as banks and other lenders, especially in a membership, a non-stock organization, and I understand that the American Automobile Association is of that nature, it

is not only commonplace but appropriate, one might also say, naturally to rely on the members for advances to get the funds necessary to carry on operations.

Q. What do you mean by a revenue or income trans-
[fol. 36] action?

A. A revenue or income transaction occurs when some organization, corporate or otherwise, furnishes a product or renders services and no revenue can emerge in the very nature of the case until product is furnished or services are provided. That I regard as an undisputable principle of accounting and it is universally recognized, as far as I know, in the accounting field.

Q. Professor, would you give us an example which would distinguish between a financing transaction and a revenue or income transaction?

A. Well, there are, of course, many examples in business operation. I might be permitted perhaps to try my hand at a very simple hypothetical example in an effort to bring out what I regard as the underlying point involved.

Suppose, Mr. Bomar, that at about the end of a taxable year you deposited $100 with your tailor in connection with an order, which he has agreed to, to make you a nice overcoat at a cost of $300. Now, assuming that we are approximately at the end of his fiscal and taxable year—I don't know that it is even necessary to throw that assumption in—but at any rate when that transaction occurs you are depositing $100 with your tailor in connection with this order for an overcoat.

Proper accounting for a tailor would require the estab-
[fol. 37] lishment of a liability account in your name for the amount of that $100 which you deposited with him as a means, perhaps, of helping to finance his purchases of materials and other costs to be incurred in the making of this coat. He is just in the same position substantially as if he had gone to the bank and borrowed $100 or you had signed his note at a bank for $100.

Now, if that is the situation still at the end of his taxable year, it is absolutely essential that he show a liability to you of $100 in his financial statement and it would be absolutely incorrect for him to treat that $100 as an income item.

Now, in the following year when he makes up the coat, buys the material and makes up the coat, he now has a revenue transaction, and the proper accounting for that would be to recognize a revenue or sale, as we often say, of $300 and a charge to you as a customer of precisely that same amount.

Now, we have arrived at the final stage of settling these two claims, your claim against him for the advance of $100 and his claim against you for providing you with a product, this coat, at an agreed price of $300.

Now, two methods of settlement are open to you: You might pay the tailor $300 and then he might pay you $100, returning the amount of your advance, which, if he had [fol. 38] borrowed from the bank, that is what he would do. Or instead of that he may deduct the $100 claim in your favor from the $300 claim in his favor and bill you for $200. That's precisely the way that invoice would be typically set out, but that does not alter the fact that in the first year we have a financing transaction in which you provide the tailor with $100 in just as clear-cut way as if he had gone to the bank to get it, and that remains a liability, I assume, at the end of the year, and the second year revenue emerges and the settlement of these claims also develops.

Q. Professor Paton, can you or not apply the principle of accounting you have discussed and illustrate it to the facts in this case?

A. Yes, I think I can as I understand the facts.

It seems to me that my little example is absolutely on all fours with the facts in this case, that when a member makes a deposit of any amount of money in advance of the rendering of service by the association or one of the constituent branches, it is clear that we have no revenue transaction, there is no such thing at that stage as revenue or income. Instead we have a bit of financing and I don't regard it of any consequence whatsoever that the amount advanced might be quantitatively of equivalent to a year's dues. I think it is at that point some people get confused about such cases.

[fol. 39] The plain fact is that at that point the Association has incurred a liability, the Association has received

funds from members in lieu of other methods of financing. Now, as through the passage of time the Association renders services as agreed, the revenue transaction emerges, and under prevailing practice an arrangement is worked out under which the liability is discharged instead of a payment by providing service as agreed. That doesn't alter one iota the fact that one transaction is raising funds and the other transaction is the revenue transaction.

Q. Professor Paton, does sound accounting practice demand that there be a distinction between the receipt of advance dues which you described as a financing transaction and the rendering of services which you describe as an income or revenue transaction?

A. Yes, it certainly does. First, I perhaps have already said I consider it a basic principle of accounting practice to draw that distinction, and I think it is universally acknowledged among accountants. I don't know of any reputable accountant that would hold anything to the contrary, and I think that is true for a long period of years.

Q. Professor Paton, the pleadings in this case make it clear that the American Automobile Association uses the [fol. 40] accrual method of accounting. Under the accrual method of accounting, is it essential that income be recognized only as services are rendered or made available?

A. Yes, it is, but I would like your indulgence to clear up something there.

In my opinion it doesn't make any difference whether the taxpayer is on the so-called accrual basis or on the so-called cash basis, as I understand the situation. Whichever basis he is on it is absolutely improper, it is unsound accounting for a taxpayer to treat money secured at the bank as if it were revenue, or money secured with which to operate, from members, as if it were revenue.

My understanding of the cash basis of accounting—and I am subject to correction, because I think I know something about this—but we do have a system under which the taxpayers—we refer to the taxpayer in that category here—is permitted under some types of circumstances to defer the recognition of revenue that has already been earned and produced until cash is received.

I report my return on the cash basis. I report the cash paid to me each year as my cash income.

Q. Professor Paton, if receipts in the form of advances by members or customers are treated as taxable income entirely in the year of receipt, is there a possibility that taxable income over a period of years will be overstated [fol. 41] and that the total tax collected from the particular taxpayer will exceed the statutory rate applicable and may even include a levy on capital funds in the guise of an income tax?

A. Yes, there is very clearly such a possibility. I might take perhaps a rather extreme example that is not literally identical to the case we are considering, but it seems to me it is the same principle. Let's suppose a new company was organized to make machine tools or some other products and the funds to build the buildings, let's say, were secured from the stockholders and funds to buy materials were secured from some interested customer who has ordered quite a number of these units of product that the company is going to make. Now, if a part of the money advanced by that customer who is making these orders were seized as income taxes, not only would we be taking money obviously raised to acquire these inventories but we would be taking money before we know whether the company is going to be able to operate at a profit.

You would seize funds that are being used to finance a business prior to the production of revenue and the assembling of the costs, and you may very well have a tax levy when there is literally no income at any point.

If, for instance, the price that was agreed upon for this customer I am thinking of weren't high enough to develop [fol. 42] some of the cost that might unexpectedly appear, it might be that the company would operate at a loss. It seems to me that in such a situation it would be ridiculous to take some of that money and call it income.

Q. When in your illustration would the income for revenue purposes take place?

A. When the goods are provided for the customer as agreed by the contract.

Q. Professor Paton, when you refer to an income or a revenue transaction are you referring in general to items which appear in a profit and loss statement, or are you not?

A. Yes, in a profit and loss or income statement. I prefer the term "income statement," but it doesn't matter and I am using them both because sometimes we find the term "revenue" and the "total sales price" and sometimes we apply the net income to a net or intermediate figure, but the elements I am thinking of are income statement elements, yes, sir.

Q. Professor Paton, can the error which you described in accounting in the case of the machine tool manufacturer happen to such an association as the American Automobile Association?

A. Well, it seems to me it clearly can. I don't know the details of the Association, but it seems to me they clearly can.

[fol. 43] If I might try to focus on something to bring out the point, let's suppose, for instance, that the Association toward the end of a taxable year staged quite a membership campaign and got quite a bit of money in toward the end of that year covering membership so that can operate as of the first of the following year. It might well happen that unexpected developments may create an element of cost when the Association undertakes to furnish the services or provide the services for the membership as agreed, a level of cost might emerge that would wipe out any possible income margin with respect to this batch of customers during the year in which revenue were being produced and costs being incurred. In fact, I would be surprised if that sort of thing wouldn't happen from time to time wherever funds are levied upon in the gross prior to the incurring of costs or the creation of the revenue itself.

Q. Professor Paton, you will note from the agreed facts in this case that the American Automobile Association recognizes advance dues as revenue or income as services are made available over a period of time of the membership. Will you please state whether or not there is any justification for recognizing as income or revenue advance dues on a time basis?

A. Well, it seems to me there is considerable justification. The contract itself is on a time basis. I feel especially [fol. 44] for tax purposes the important thing is that the

year's recording be handled in such a way that for the year the transactions with members are treated soundly, as I have tried to suggest. The time basis does not offend me at all. I would doubt if there is any other basis that is more realistic, especially when you consider the practical side of it and the way the thing is regarded by both the Association and the member.

I might say I am probably one of the oldest members of the Michigan Automobile Association and it is my understanding when I deposit my dues that over a stated period of time the thing that I am acquiring is the right to receive a series of services of one sort or another specified in the arrangement, and hence proration over a time, as time passes, strikes me as being perfectly realistic and reasonable.

Q. Professor Paton, Mr. Arthur I. Cooper has testified that even had advance dues been pro rated as costs were incurred on an average cost per member per month basis, that the recognition of revenue during a particular year and the amount of the liability as of the end of the year would not have been materially different than if revenue is recognized out of the advance deposits on a time basis. Would that testimony fortify your conclusion that time is a proper yardstick for measuring the obligation that the [fol. 45] American Automobile Association is performing or the expiration of its liability to render services?

A. Yes, I think it would to some extent. That is, I would be inclined to recommend that such study be made from time to time just as a means of seeing whether the relationship can be properly recorded on a time basis.

My feeling still is that time basis is thoroughly sound and that cost data of the kind presented that I was listening to this morning, are primarily important for the purpose of testing the general reasonableness of the time basis and seeing whether there is anything capricious or outlandish about such basis.

Q. The feeling has been expressed by others that such a method of accounting would be artificial if advance dues were recognized on a time basis unless it was proved that there was a relationship between the income and the services to be rendered. Do you agree with that view from the accounting point of view?

A. No, I don't agree with that point of view or any other point of view as far as understanding the operations of an automobile club or an association, though such understanding as I have, if anybody can find a better basis I would like to see them do it.

The Club, the Association, by contract agrees to provide a package of services and conditions. Now, fluctuations [fol. 46] between months, if there were such, wouldn't frighten me particularly, because I would be looking back as a whole, and I think time is a very good and realistic basis for saying that the Club has undertaken to provide a package of services over a period of time, but I don't object, on the other hand, to studies which I think should be made from time to time to test things out and see how other aspects of the situation fortify or raise questions about the time basis. I wouldn't want to insist here the time basis is the only basis with which one might spread the revenues of a service organization.

Q. Professor Paton, if you were employed by the American Automobile Association as an independent expert to advise them how to set up their books and records in order to reflect and recognize advance dues on a proper basis, what method would you recommend?

A. Well, I might quibble a little bit about the account titles, maybe prefer something a bit different, but I would emphatically recommend that the Association's usual method of accounting which sets up at the end of each year on a reasonable basis the outstanding obligations to members as a liability and to recognize revenue as services are rendered or made available through the year. In fact, I can't see any justification for anything else. Now, I understand that is what the Association has been doing for many [fol. 47] years, and if my understanding is correct I wouldn't have any quarrel with them on any essential points whatsoever.

Q. Professor Paton, is the method of accounting for advance dues which the Commissioner of Internal Revenue seeks to impose upon the American Automobile Association in accord with generally accepted accounting principles?

A. No, sir, it is not. It is absolutely 100 percent in conflict and always has been where it has been tried, and I

might add it is entirely indefensible. It should not even be considered debatable, and I was disturbed for many years handling this correctly, in income tax and other connections we started trying to do the wrong thing.

Q. Professor Paton, I call your attention to page 282 of the book to which you have referred, "Corporation Accounts and Statements," wherein you write:

> "The term 'deferred revenue' is sometimes applied to balances representing amounts collected from customers or clients in advance of the delivery of goods or the furnishing of service. As emphasized later, such balances are *liabilities, not revenue credits deferred* or otherwise."

Does the statement which I have quoted apply to the account entitled "Deferred Revenue—Membership Dues" referred to in Paragraph 7 of Plaintiff's Petition?

A. Oh, yes, clearly that is an example of the very kind [fol. 48] of situation I have in mind there, but those balances are clear-cut liability balances and I personally prefer to describe them as advances by customers or something of that kind rather than just a particular type.

Q. I also ask you to turn to page 416 of the same book, of which you and your son are the authors, and in which you write:

> "A type of liability frequently misinterpreted is represented by 'unearned' or 'deferred' revenues so-called . . . the proper general caption for such item is 'Advances by Customers' and that should be reported in clear-cut fashion under liabilities."

You continue on page 417:

> "In a number of cases the Internal Revenue Service has taken the almost incredible position that advances by customers constitute revenue for tax purposes in the period received, even if the taxpayer's accounting is on a strict accrual basis and even if no goods or services have been delivered in such period."

s this still your view?

A. It most certainly is and it always has been, I might say, as we considered this a very elementary point in accounting, and I have never heard of anything ever being preached in a classroom or anywhere else.

[fol. 49] Commissioner Bennett: You have taught it that way for 44 years?

The Witness: Yes.

Commissioner Bennett: And when was your book published from which the quotation has been made?

The Witness: This particular book, Your Honor, was published in 1955, but you will find the same material I have written with the exception that in most of them you won't find this comment about the Internal Revenue Service.

By Mr. Bomar:

Q. Professor Paton, we have been talking about the income account of the Association primarily. I want now to direct your attention to the balance sheet as contrasted with the income account. The balance sheet of the American Automobile Association is evidence in this case established here and always as a liability account, which is referred to as "Deferred Revenue Membership Dues." Does sound accounting practice require this amount to be shown as a liability on the balance sheet of the American Automobile Association?

A. In my judgment it most certainly does. It is a liability.

Q. Professor Paton, would you as a certified public accountant certify to the accuracy of the income statement or the balance sheet of the American Automobile Association if the Commissioner succeeds in changing its method of accounting?

[fol. 50] A. No, I certainly would not even consider it for a moment. The thing is unsupportable and I wouldn't know offhand of any professional accountant who would say differently.

Mr. Bomar: Thank you, Professor Paton.

Mr. Kane: May we have a short recess, Mr. Commissioner?

Commissioner Bennett: We will take a ten-minute recess.

(Short recess taken.)

Commissioner Bennett: Proceed.

Cross Examination.

By Mr. Kane:

Q. Professor, you talked about the accrual method of accounting and deferred revenue or deferred receipts method. In normal accrual accounting, as I understand it, you take into account the amount when it is billed to a customer whether or not at that point you have rendered the service to that client; isn't that right?

A. No, sir.

Q. It is not right?

A. No, sir.

Q. In other words, if I go to a store and purchase a suit in late December which is not furnished to me until some time in January, the store bills me the 30th of the month, the 30th of December, they do not accrue that as income in December?

[fol. 51] A. I couldn't guarantee that there is no store that does not violate the principle, but that is something we are very touchy about in accounting. That would not be correct accrual accounting for revenue to be credited—you used the word there—in December with a sale in which the furnishing of the product doesn't occur until later.

Now, there is one possible exception to that, sir. If the circumstances were such that the coat was already in existence and was segregated as the property of the customer, it is the exception but I don't think we need refer to it in the retail situation, but there might be instances the fact that the product had not physically left the possession of the vendor would not be the decisive thing provided the product is there waiting delivery and all the conditions have been taken care of. For instance, a wholesaler might order a big shipment of cans from a canning factory for canning tomatoes, let's say, and if the customer had those tomatoes on hand and set them aside as the property of the customer, I would be willing to say that under some of those condi-

tions you do have a revenue transaction and that the billing is validated by a revenue transaction. But, speaking generally about manufacturing and trading companies, I would say that the last thing in the world any of us would tolerate in accounting would be the inclusion in revenue in the current year of prospective sales even though normal billing or [fol. 52] formal billing had been instituted.

Q. If they billed me in December and the coat was delivered to me in December and I did not pay for it until some time in February or didn't pay for it at all, when would it be accrued as income?

A. In that situation the revenue would be recognizable under proper accounting in the month of December regardless of the fact that the transaction might turn out to be a bad debt. In other words,—

Q. An adjustment would be taken in the following year as a bad debt?

A. The bad debt loss would occur later when the account went sour.

Q. Professor Paton, you called these dues, in effect, advances from the members. Now, you also said, I believe, that advances are usually thought of as subject to a service being performed or a refund being made if the service is not performed. I believe you used a hundred dollar example.

A. Yes, I didn't say specifically anything about refund.

Q. But I am asking you about refund.

A. Okay.

Q. I think it follows in the same order. Do you know if the dues in this case are subject to refund?

A. I don't know for certain about that, sir.

[fol. 53] Q. May I ask you do you know as a member of the Michigan Automobile Club, which you say you have belonged to for many years, whether there are or have been years in which you required no service?

A. There have been years in which I did not require them to pull me out of the ditch or anything of that kind, but I do not consider that is what I am paying for. I am buying the availability of the service, I am buying the protection and that is what I am paying them for when I take out member-

ship. I hope they will not have to pull me out of the ditch, in fact.

Q. The same as insurance?

A. I consider it a very close relationship between an insurance situation and this type of situation with regard to the type of product.

Q. But it is conceivable they have a few cases, a few members or many members who ask for nothing as an item of direct expense to the organization during the following year. I am not talking about overall management salaries but pulling a man out of a ditch, asking for travel folders. Is it possible there would be many members that would ask for no service of that type during a year?

A. Oh, yes, I think that is clearly involved. You are dealing with a group or pool. Any pooling or risk situation, particular members may in a particular year require [fol. 54] very little of a specific service that is rendered to certain other members. I wouldn't know what the experience on that would be, but I would think it would be rather irregular between individual members.

Q. But your fixed liability as you see it in contrast to the overcoat transaction is their being liable to render these services?

A. Well, I have always understood that is what I am buying and that is the regular understanding that I am buying the availability of services, the protection and paying for it reasonably, and I hope I won't have any bad luck.

The specific intentions, they are agreeing to furnish certain services—there is a considerable difference, I might add, on varying types of business of that kind. Frankly, the irregularity of the actual furnishing of the maps and helping you out when you run out of gasoline and so on, I frankly don't think that has a blessed thing to do with the over-all accounting.

Q. Now, this view of others that you mentioned you took issue with, would you mind clarifying for the record whose views they are?

A. I was asked, I believe, a question to this effect, that there are others who regard the recording or recognizing of service on a time basis as artificial. There was nothing mentioned as to who these others are in question, but my

[fol. 55] answers simply were if there are folks of that stripe I don't agree with them.

Q. It might be the Supreme Court?

A. Are you asking me, sir?

Q. Yes. You heard the testimony this morning and the opening statement?

A. Yes. I am not familiar with the details of the Michigan case, but I am quite sure I saw reference to it in the papers originally and I heard what was said here today and have some little familiarity with it, and I don't know what facts were presented to the Court, but on this particular point we have under consideration here now the Court reached absolutely the wrong decision.

Mr. Kane: That is the reason for my objection to this type of testimony, Your Honor, it is an advisory opinion.

By Mr. Kane:

Q. Now, there were some charts shown here about expenses. You said that you believed that the proper method was to pro rate on a time basis the dues, that expenses as I recall it would be for testing purposes from time to time to see how your system was working out. Is that a fair statement?

A. Yes, that is my recollection. I just add this word, that I consider the basic question I have been addressing myself to, this question of making sure we have a liability [fol. 56] appropriately calculated set up at the end of each accounting period and that the revenue transaction and the services rendered be recorded over a period of time in a reasonable way.

Now, I don't hold any rigid plea for a strict time basis. It looks to me as though it is the most realistic and practical and sensible in this situation.

Q. You would say, then, that it wouldn't be proper to prorate expenses over the same year? A. No, I wouldn't say that.

Q. You would not say that it was not proper to prorate expenses?

A. No.

If I might elucidate very briefly on that. The accounting that is on an income statement, I regard in this way: The

measure of the revenue up at the top of the statement I think is a relatively simple thing. The determination of the costs that are properly applicable to that revenue is a much more controversial subject. I don't think we in accounting do as good a job in that area in general as we do in the area of simply setting up the revenue figure at the top of the income statement, but I am a thorough-going believer in our perfecting our charges for deductions in so far as it is feasible and practical to do so, so that we have a reasonable relationship between the charges and the [fol. 57] revenues.

Q. I believe you testified that in effect this method that the Commissioner advocates would at times result in his taxing as income either capital or loans not actually earned; is that correct, sir?

A. It seems to me it is quite likely to result. You are levying a tax upon receipts that in the first instance are funds advanced to finance activities, so you are levying a tax to start with on a gross figure. It seems to me quite possible, quite likely in fact, that from time to time the levying of a tax prior to the creation of a revenue and the expense accounting will result in seizure as income taxes of funds that are not income in any sense of the word.

Q. Now, that is from time to time, in other words, not just at the beginning of the business but from time to time to put some changes in the number of memberships that will occur?

A. Yes, unexpected changes in expenses, loss periods and so on. Now, I haven't worked out any examples to my satisfaction in detail in that area, but that's my impression, and, of course, we can see at the beginning of a business, we can see the thing more clearly, but what I do from time to time say, that that situation would arise after the operating history, after you got rolling presumably from time to time. But I don't think we can hope that there will be a [fol. 58] coincidence from year to year between the advances by customers and any organization that utilizes that method of finance and the volume of service and product produced in that year. That would be a sheer coincidence if they are identical. That creates the possibility of levying taxes on funds that not only are not income to start with

but will never be in any sense of the word an element of net income.

Q. Now, continuing that, as long as you have a curve upward of members and you are prorating part of the income into the next year for the revenue, gross receipts, wouldn't it follow that if the expenses were increasing to serve more members that you would be putting in part of the expenses in the latter months of the year, you would be increasing the expenses so that your net income would always be less as long as you have an upward curve of members?

A. I am not sure I follow you. I don't see anything about an automobile association, or, for that matter, any other business which deserved the general conclusion that there will be a trend upward of revenues or a trend upward or downward of expenses. That would depend on a lot of circumstances, but, to my mind, sir, there is a fatal defect in taking money as income before income emerges, in that you have deprived the taxpayer of funds too early, and in the second place you run the risk, but even year by year there will be substantial injustice done. That's a question I think [fol. 59] you would have to postulate a lot of facts rather carefully how it would work out.

I am not trying to evade your question, but I don't know the answer.

Q. My question is premised on exhibits put in by the Plaintiff, and I note that each year's expenses have gone up anywhere from three or four hundred thousand dollars to over a half million dollars in an exhibit right here, and my question is premised on the fact that some of those expenses during those years may have been applicable to the new memberships, the income from which is being turned over into the next year under the Plaintiff's method of accounting.

A. Oh, I think that is quite possible, that some of the costs that are incurred and are recorded as expenses currently by the Association, that we could find fault possibly with some treatment there. I wouldn't think in the automobile association business that they would be as serious as we might find in manufacturing and some other cases, but I would recommend, as I understand the Associa-

tion follows, [illegible] practice of spreading the commissions to salesmen, because they relate to a particular element received from the members.

Now, I wouldn't, on the basis of any information I have, want to be either critical or applaud the general treatment of this and that cost like office supplies and salaries of ste- [fol. 60] nographers and others. I don't know of anything strikingly wrong about that area of accounting for the Association, but I can't testify to the advantage or disadvantages of the things they are doing.

I said a little while ago, and I would like to refer to that in the field of determining the cost assigned to the volume of sales or services rendered, we do have a lot of difficult accounting questions.

Q. Why would you say that the salesmen's commissions that you just referred to are more direct expense than publications, road service or any of those things, other expenses incurred for a member?

A. Well, I don't know that I know enough about the operations of the Association to speak very positively on that, but it does seem to me that the commissions specifically related to amounts advanced by customers, that there should be some justification for spreading through the year by months especially if you are going to spread services rendered by months through the years, and wherever anything of that kind is substantial, I think you improve your accounting somewhat by appropriate spreading.

Now, when you come into the field of publication costs that is something like the question of advertising in business generally. I remember when I was in the Internal Revenue Service 40 years ago for a year, that we were [fol. 61] worrying about advertising cost, whether we should permit advertising cost as a deduction in the year in which the money was spent or the billing occurred, like some late advertising in the Saturday Evening Post, say, about this time of year, or whether we should try to insist on some method of deferral and, generally speaking, the method of deferral. You didn't try to do much with it because of the great difficulty in deciding when the results of some of these expenditures might be. Now, publication expense, I don't think I should pass judgment on that. I don't think I know enough about it, Mr. Kane.

Q. You gave as the only thing they now prorate is the salesmen's commissions.

A. Yes.

Q. In this case.

A. One other thing, I think it was mentioned the cost of accident insurance was prorated also.

Q. Yes, accident insurance. No, it is not prorated.

A. I understood it was and always had been.

Q. You heard some testimony this morning as to the change in 1954, which is the same thing we are talking about, and there was also mention of items on the books as of the end of the year, a small figure, roughly $44,000, which they treated as an accounts receivable in a memorandum form only, which was not placed on the books. Would you [fol. 62] say that proper accounting as described this morning would require them to include that or a portion of that $44,000 in their income for 1954 when they had been doing it each year up until then?

A. As I understand the change, and I may not be entirely clear on this, but as I understand the change it would not result in inconsistent accounting or any material change, because I would regard accounts receivable that had been set up at the time the application is received and no funds had yet come in as a sort of memo account and the corresponding credit in deferred revenue account or whatever you call it, I would call an offset and I would say the offset was a change in these two methods of accounting. That would seem to me preferable to what they would be doing previously and not inconsistent with it.

I am not undertaking to say that an accountant from absolutely every standard knows anything about it, but I don't see that that particular change is substantive to the matter I have been addressing myself to here.

Mr. Kane: I have no further questions.

Redirect Examination.

By Mr. Bomar:

Q. Professor Paton, Mr. Kane asked you your opinion as to whether the American Automobile Association had a

practice of making refunds to members, and as I recall your [fol. 63] testimony you stated that you didn't know. Would it make any difference under sound accounting practices from the viewpoint of distinguishing a financing transaction from a revenue transaction whether the Club does or whether the Club doesn't make refunds?

A. I don't think so. It is an incidental thing which would draw a little distinction advanced by a customer and a member and a bank loan, but if in incidental cases refunds were restricted or were not available it doesn't seem to me that alters the basic proposition that the money advanced by the customer is an advance and is not revenue.

Now, some subsequent development might involve some small adjustment, I don't know, but I think I can state that pretty clearly and flatly that I can't see that that fact settles the question at all of what is a revenue transaction there and what is a financing transaction. To me the advance by the member is the provision of some funds prior to the emergence of revenue.

Q. Professor Paton, under sound accounting practices is there any point in deferring expenses or in postponing the deduction for an expense unless it is a truly prepaid expense?

A. Well, that is a big question, Mr. Bomar. I think that the association of expenses with revenues is a difficult ques- [fol. 64] tion and involves many debatable points, because what we are really after is economic associates, and the word "prepaid" is a little bit restrictive to cover all such cases.

Q. Professor, is it debatable as to whether the advance dues should be deferred?

A. In my judgment it is not debatable and never has been.

Q. Professor, are you stating that even though no expenses are deferred, that you should still distinguish between advance dues and the recognition of dues as income?

A. There isn't any question in my mind but it is improper accounting to treat as a revenue, advances prior to the rendering of service, and that in itself—I am not going to condone any bad accounting for expenses by saying

that, but that's a distinct, basic consideration in getting started with your accounting at all.

Mr. Bomar: Thank you.

Recross Examination.

By Mr. Kane:

Q. Didn't you say that the normal advance for loan as we think of it would indicate the right to a refund if the service was not rendered?

A. It depends on the way the contract is drawn, but I think of the person or entity receiving such advances from [fol. 65] customers and members as incurring an obligation and the proper utilization of those funds or the return of such funds, and I don't know enough about all the types of contracts we have in this area just to know when a refund is in order.

We know sometimes in the fire insurance business you are entitled by agreement and sometimes by request to a refund, so that generally speaking the producing entity does unquestionably incur the obligation. Now, what the basic law is I couldn't say.

Q. We are not asking you the law, Professor. Wouldn't you say that is true in subscription income, that normally if you cancel your subscription, like a newspaper subscription, that you are entitled to a refund?

A. I was under the impression that quite frequently you are not.

Q. On a long-term contract?

A. That I am not sure of. If you had a four or five-year subscription—my impression is that those contracts usually provide that you are not entitled to a refund, but what the practice is I couldn't be positive.

Mr. Kane: I have no further questions.

Commissioner Bennett: Thank you, Professor. You may be excused.

(Witness excused.)

[fol. 66]

IN THE UNITED STATES COURT OF CLAIMS

No. 311-58

AMERICAN AUTOMOBILE ASSOCIATION,

v.

THE UNITED STATES.

Mr. Fleming Bomar for the plaintiff. *Messrs. Joseph E. McAndrews* and *Ivins, Phillips & Barker* were on the brief.

Mr. Jerry M. Hanovit, with whom was *Mr. Assistant Attorney General Charles K. Rice,* for the defendant. *Messrs. James P. Garland* and *Lyle M. Turner* were on the brief.

OPINION—Decided March 2, 1960

JONES, *Chief Judge,* delivered the opinion of the court:

The plaintiff, a motor club, seeks to recover Federal income taxes and assessed interest paid for the calendar years 1952 and 1953. The issue to be decided here involves the tax treatment to be accorded the prepaid income of an accrual basis taxpayer. The problem arises because club membership dues are paid to the taxpayer for 12 months in advance.

Plaintiff is a national organization which renders services to affiliated local automobile clubs and their members and performs services of a public nature in fields relating to motoring and travel. In addition to its activities as a national organization, the plaintiff operates directly, as divisions, ten local automobile clubs. A substantial portion of the annual gross income of plaintiff is derived from dues, prepaid for one year in advance, received from members of the automobile clubs operated as divisions of the plaintiff.

Plaintiff provides services for the members of the local divisions over the 12-month period following payment of

[fol. 67] dues. These services, although not completely uniform, generally included the following: (a) A travel service which included trip planning, tour books, accommodation directories, maps and recommended routes; (b) emergency road service which consisted of towing, changing tires, replacing batteries and other minor repairs; the road service was provided by plaintiff through contracts made with garages and service stations in the areas served by its divisions; (c) bail bond protection up to $5,000 through contracts made by the plaintiff with bondsmen; (d) personal automobile accident insurance; (e) a theft reward offered by the plaintiff for information leading to the arrest and conviction of any person stealing a member's car; (f) in addition, the plaintiff, in one or more of its divisions, provided other personal services for members which included procuring motor licenses, notarial services, brake and headlight adjustments, and advice on how to prepare and file papers in small claims courts.

The prepaid dues collected from members of its divisions were deposited in plaintiff's bank accounts with no restrictions as to their use for any of its corporate purposes. However, the dues upon collection were reflected in a liability account designated "Deferred Revenue—Membership Dues." Thereafter, a pro rata part of the dues was removed from the liability account and reflected in an "income" account. Dues collected from members who joined in the month of January were recognized as income in January only to the extent of 1/24 (a half of 1/12) of such collections, on the assumption that the average or mean date of the January collections would be the middle of the month.[1] Thereafter, 1/12 of the dues collected in January was taken out of the liability account and credited to income in each of the following 11 months (i.e., February through December). The remaining 1/24 of the dues collected in January was kept as a liability in the "Deferred Revenue—Membership Dues" account on December 31, but was subsequently recognized as income for January of the following year.

[fol. 68] Dues collected in each of the other months of the

[1] Plaintiff's taxable year was the calendar year.

calendar year were treated in the same manner. That is, 1/24 of each month's collections was recognized as income in the first month of membership, 1/12 of the amount paid was recognized as income in each of the following eleven months, and the remaining 1/24 was allocated to income in the month when membership expired. Commencing in 1954, the plaintiff, in order to simplify internal accounting detail, changed its procedure in the monthly accounting for dues by assigning 50 percent of the dues to income for the current year and allocating the other 50 percent as a liability which matured as income in the following tax year.

In preparing its income tax returns for the years in suit, plaintiff, an accrual basis taxpayer, excluded from the income received in each year that portion of membership dues which remained in the liability account ("Deferred Revenue—Membership Dues") at the end of the taxable year. It thus treated dues as income ratably over the 12-month period of membership, whether or not such period extended beyond the close of its taxable year.

Expenses which plaintiff considered to fall within the category of prepaid membership costs, e.g., salesmen's commissions and the cost of accident insurance covering the period of a membership, even though paid by plaintiff, were not deducted entirely in the taxable year paid or incurred, but instead were deducted ratably over the same periods of time that dues were recognized as income.

The income reported by plaintiff in its tax return for the calendar year 1953 attributable to dues received from members of its divisions was $3,337,813.44, representing $1,562,042.23 of prepaid dues collected in 1952 but not recognized as income until 1953, plus $1,775,771.21 of dues collected in 1953 and recognized as income in that year.

For 1954, dues reported by plaintiff as income for purposes of the Federal income tax totaled $3,794,672.20, representing $1,755,407.46 of advance dues collected in 1953 but not recognized as income until 1954, plus $2,039,264.74 of dues collected in 1954 and recognized as income in that year.

Plaintiff claimed that as a result of a 1954 net operating loss in the amount of $289,967.67, it was entitled to a net operating loss carryback *deduction* in 1952 in the amount [fol. 69] of $154,411.11, and a net operating loss carryback

deduction in 1953 in the amount of $135,556.56. Upon examination of the plaintiff's Federal income tax returns for the calendar years 1952, 1953, and 1954, the Commissioner of Internal Revenue disallowed plaintiff's deferral of income from one year to another, for years subsequent to 1953, thereby increasing plaintiff's 1954 net operating income from $353,279.09 to $481,557.59 and reducing plaintiff's 1954 net operating loss from $289,967.67 to $14,412.49. The net effect of the Commissioner's determination was to reduce plaintiff's net operating loss carryback deduction to $14,412.49 in 1952 and to eliminate entirely any net operating loss carryback deduction in 1953.

The issue to be decided by this court is whether the Commissioner of Internal Revenue correctly determined that plaintiff's method of accounting—with respect to dues received from members of its divisions—does not clearly reflect plaintiff's income within the meaning of § 41 of the Internal Revenue Code of 1939 and § 446 of the Internal Revenue Code of 1954. Section 41 required that "the net income shall be computed . . . in accordance with the method of accounting regularly employed in keeping the books . . . but . . . if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income . . . ."[2]

The Commissioner of Internal Revenue disallowed the deferral of income from one year to another on the ground that prepaid dues received under a "claim of right," without restriction as to their disposition, represents income in the year of *receipt* and should be taxed in that year regardless of the method of accounting employed by the taxpayer. This position is based on the claim of right doctrine enunciated by the Supreme Court in *North American Oil Co.* v. *Burnet*, 286 U.S. 417, 424 (1932). It is of

[2] To the same effect, § 446, Int. Rev. Code of 1954, provides that: "Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." However, "if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income."

course fairly obvious that, once it is determined that pre-[fol. 70] paid income is required to be included in income in the year of receipt under the claim of right doctrine, it would necessarily follow that any other method of reporting would not "clearly reflect the income."

The opposite view, advanced by the plaintiff—that the claim of right doctrine does not relate to the question whether items that admittedly belong to the taxpayer may be attributed to a taxable year other than that of receipt in accordance with principles of accrual accounting—has been succinctly presented by Mr. Justice Harlan, dissenting in *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180, 191-192 (1957).[3]

However, we do not find it necessary to resolve this issue, since we agree with the Government's contention that the method of treatment of prepaid automobile club membership dues employed by the plaintiff was dealt with by the Supreme Court in *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180, rehearing denied, 353 U.S. 989 (1957), and was held to be, at least for Federal income tax purposes, "purely artificial." In the *Automobile Club of Michigan* case prepaid membership dues were credited upon receipt to an account carried as a liability and designated "Unearned Membership Dues." *"During the first month of membership and each of the following eleven months one-twelfth of the amount paid . . .* [was] *credited to an account designated 'Membership Income.'* This method of accounting was followed by petitioner [a motor club] from 1934. The income from such dues reported by petitioner in each of its tax returns for 1943 through 1947 was the amount credited in the year to the 'Membership Income' account." 353 U.S. at 188. (Emphasis supplied.)

[3] "[The claim of right] doctrine, it seems to me, comes into play only in determining whether the treatment of an item of income should be influenced by the fact that the right to receive or keep it is in dispute; it does not relate to the entirely different question whether items that admittedly belong to the taxpayer may be attributed to a taxable year other than that of receipt in accordance with principles of accrual accounting." (*Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180, 191-192 (dissenting opinion) (1957).)

The Commissioner of Internal Revenue had determined that this method of accounting—which is essentially the same method used by the plaintiff in the case at bar—did not clearly reflect income. The Supreme Court, in affirming the action of the Commissioner, stated (353 U.S. at 189-190):

> [fol. 71] The petitioner does not deny that it has the unrestricted use of the dues income in the year of receipt, but contends that its accrual method of accounting clearly reflects its income and that the Commissioner is therefore bound to accept its method of reporting membership dues. We do not agree. • • • *The pro rata allocation of the membership dues in monthly amounts is purely artificial and bears no relation to the services which petitioner may in fact be called upon to render for the member.* Section 41 vests the Commissioner with discretion to determine whether the petitioner's method of accounting clearly reflects income. We cannot say, in the circumstances here, that the discretionary action of the Commissioner, sustained by both the Tax Court and the Court of Appeals, exceeded permissible limits. See *Brown* v. *Helvering,* 291 U.S. 193, 204-205. [Emphasis supplied.]

Although it would appear that *Automobile Club of Michigan* does not expressly rule out deferral of income,[4] we are constrained to interpret this language as a rejection by the Supreme Court of the accounting method advanced by plaintiff in the case at bar.

We are influenced in our decision by the language used by the Court to distinguish on their facts *Beacon Publishing Co.* v. *Commissioner,* 218 F. 2d 697 (10th Cir. 1955) (deferral of prepaid magazine subscription income) and *Schuessler* v. *Commissioner,* 230 F. 2d 722 (5th Cir. 1956) (reserves set up to meet future costs):

> In *Beacon,* performance of the subscription, in most instances, was, in part, *necessarily* deferred until the

[4] See *Automobile Club of Michigan* v. *Commissioner,* 353 U.S. at 192-193 (dissenting opinion).

publication dates after the tax year. In *Schuessler*, performance of the service agreement required the taxpayer to furnish services at *specified times* in years subsequent to the tax year. In this case [as in the case at bar], substantially all services are performed only upon a *member's* demand and the taxpayer's performance was not related to *fixed dates* after the tax year. We express no opinion upon the correctness of the decisions in *Beacon* or *Schuessler*.[5]

But regardless of the underlying basis for the Court's rejection of "the pro rata allocation of the membership dues [fol. 72] in monthly amounts" as "purely artificial," we feel constrained by the decision in *Automobile Club of Michigan* to reject that same method of accounting for tax purposes in the case at bar.[6]

The plaintiff is therefore not entitled to recover and its petition will be dismissed.

It is so ordered.

Littleton, Judge (*Ret.*); Laramore, Judge, and Madden, Judge, concur.

WHITAKER, *Judge*, concurring:

From the enactment of the Corporation Excise Tax Act of 1909 and the first income tax act in 1913, it has been universally supposed that in order to "clearly reflect income" the taxpayers' accounting method must treat as gross income amounts received or accrued in the taxable year, with certain exceptions specified in the Code. The income under consideration here was received in plaintiff's taxable year. Plaintiff's method of accounting treats a portion of that income as not having been received in the taxable year and, thus, does not clearly reflect its income, unless it comes within the statutory exceptions. Those exceptions are, for example, reserves for depreciation, obso-

[5] *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. at 189, fn. 20. (Emphasis supplied.)

[6] Cf. *Bressner Radio, Inc.* v. *Commissioner*, 267 F. 2d 520, 528-529 (2d Cir. 1959); *Automobile Club of Southern California* v. *United States*, Civil No. 1169-58, S. D. Cal., January 22, 1960.

lescence, and depletion, and, in the case of insurance companies prepaid premium reserves. The statute does not allow the deduction of reserves to anticipate expenses of meeting the demands of plaintiff's membership. What plaintiff, in effect, seeks to do is to deduct such a reserve from the income it received within the taxable year.

I also concur in the majority opinion.

Findings of Fact

The court, having considered the evidence, the report of Trial Commissioner Marion T. Bennett, and the briefs and argument of counsel, makes findings of fact as follows:

1. Plaintiff is a corporation with its principal office at 1712 G Street, Northwest, Washington, D.C. Plaintiff was incorporated in the year 1910 under the laws of the State of [fol. 73] Connecticut and was organized and is operated as a non-stock, membership corporation.

2. Plaintiff is a national organization which renders services to affiliated local automobile clubs and their members and performs services of a public nature in fields relating to motoring and travel.

3. In addition to the activities described in paragraph two above, plaintiff operates directly, as divisions, the following local automobile clubs:

District of Columbia Division of AAA
(Metropolitan area, Washington, D. C.)
Louisiana Division of AAA (entire state)
Massachusetts Division of AAA (part of state)
New Hampshire Division of AAA (entire state)
New Mexico Division of AAA (entire state)
North Florida Division of AAA } (part of state)
South Florida Division of AAA }
Texas Division of AAA (part of state)
Wisconsin Division of AAA (entire state)
Wyoming Division of AAA (entire state)

4. A substantial portion of the annual gross income of plaintiff is derived from dues, prepaid for one year in ad-

vance received from members of the automobile clubs described in paragraph three and operated as divisions of plaintiff. Plaintiff provides services for such members over the 12-month period following payment of dues. The services provided by plaintiff for the members of its divisions during the years in issue, although tending to be parallel, were not completely uniform and included the following: (a) A complete travel service which included trip planning, tour books, accommodation directories, maps and recommended routes. (b) Emergency road service which consisted of towing, changing tires, replacing batteries and other minor repairs. The road service was provided by plaintiff through contracts made with garages and service stations in the areas served by its divisions. (c) Bail bond protection up to $5,000 through contracts made by the plaintiff with bondsmen. (d) Personal automobile accident insurance which included hospitalization, personal injury and death benefits on a sliding scale in the event of a motoring accident. The plaintiff contracted for the insurance on a group basis and paid the premiums on the group policies. [fol. 74] (e) A theft reward offered by the plaintiff for information leading to the arrest and conviction of any person stealing a member's car. In addition, the plaintiff, in one or more of its divisions, provided other personal services for members which included procuring motor licenses, notarial services, brake and headlight adjustments, and advice on how to prepare and file papers in small claims courts.

5. In order to make available and provide for the members of its divisions the services which plaintiff provides, plaintiff during the years in issue owned or rented offices in 39 to 41 different geographical locations and had on its divisions' payroll 495 employees in December 1953 and 603 employees in December 1954.

6. Plaintiff, commencing with the calendar year 1943, has been required to file Federal income tax returns and to pay Federal income taxes on its net income. Its Federal income tax returns are filed with the District Director of Internal Revenue, Baltimore, Maryland. The plaintiff's taxable year is the calendar year.

7. Plaintiff employs the accrual method of accounting in keeping its books and records and in filing its Federal income tax returns.

8. Plaintiff, within the time prescribed by law, filed Federal income tax returns with the District Director of Internal Revenue, Baltimore, Maryland, for the calendar years 1952, 1953 and 1954. The 1952 return reported a net income of $152,975.51, the 1953 return reported a net income of $352,125.84, and the 1954 return reported a net operating loss in the amount of $290,186.04.

9. Upon examination of plaintiff's Federal income tax returns for the calendar years 1952, 1953 and 1954, the Commissioner of Internal Revenue made several minor adjustments which are not in issue in this proceding, the net effect of which was to increase plaintiff's 1952 net income to $154,411.11, to increase plaintiff's 1953 net income to $353,279.09, and to reduce plaintiff's 1954 net operating loss to $289,967.67.

10. Plaintiff claimed that as a result of its 1954 net operating loss in the amount of $289,967.67, it was entitled to a net operating loss carryback deduction in 1952 in the [fol. 75] amount of $154,411.11, and a net operating loss carryback deduction in 1953 in the amount of $135,556.56.

11. Upon examination of plaintiff's Federal income tax returns for the calendar years 1952, 1953 and 1954, the Commissioner of Internal Revenue also determined not to recognize the method of accounting employed by plaintiff in computing its income derived from prepaid dues collected from members of its divisions during the calendar years 1953 and 1954, which is the issue in this proceeding. The net effect of such determination was to increase plaintiff's 1953 net income from $353,279.09 to $481,557.59 and to reduce plaintiff's 1954 net operating loss from $289,967.67 to $14,412.49, with the further result that the Commissioner reduced plaintiff's net operating loss carryback deduction from $154,411.11 to $14,412.49 in 1952 and eliminated entirely any net operating loss carryback deduction in 1953.

12. The Commissioner of Internal Revenue determined the increase of plaintiff's income for 1953 by $128,278.50

and the reduction of plaintiff's loss for 1954 by $275,555.15 was in the following manner:

	1953 Adjustments	1954 Adjustments
Reserve for unearned and deferred income Dec. 31 of current year	$1,756,485.46	$2,039,264.43
Less reserve for unearned and deferred income Dec. 31 of prior year	1,562,042.23	1,756,485.46
Difference	194,443.23	282,778.97
Less		
Prepaid commissions:		
Dec. 31 of current year	398,482.36	405,706.15
Dec. 31 of prior year	332,317.63	398,482.36
Difference	66,164.73	7,223.79
Net additional income determined for the current year	128,278.50	275,555.18

All of the foregoing items are reflected in the plaintiff's balance sheets as of December 31 for the years involved, which were filed with its income tax returns for 1953 and 1954. The liabilities contain the account UNEARNED AND DEFERRED INCOME, and the assets contain the account PREPAID COMMISSIONS, but the latter account is not involved in the [fol. 76] items labeled prepaid commissions in the above tabulation. The deduction items employed by the Commissioner of the Internal Revenue Service represent plaintiff's asset account for prepaid membership costs. The plaintiff's assets for 1954 do not reflect any amount for prepaid membership costs, but its liabilities for unearned and deferred income reflect the approximate net difference between $2,039,264.43 and $405,706.15 in its 1954 balance sheet.

13. As a result of the adjustments described heretofore, the Commissioner of Internal Revenue on May 15, 1956, asserted an income tax deficiency against plaintiff in the amount of $58,083.58 for the calendar year 1952, and in the

amount of $137,907.48 for the calendar year 1953. These deficiencies in tax, plus interest of $2,019.37 for the year 1952 and $10,789.77 for the year 1953, were paid by plaintiff on May 25, 1956, and May 28, 1956.

14. On May 10, 1958, plaintiff filed timely claims for refund for each of the years in suit, which claims for refund raised the issues upon which plaintiff now seeks recovery in this action. On July 1, 1958, the Commissioner of Internal Revenue notified plaintiff by registered letter that its claims for refund had been denied.

15. Plaintiff, a nonstock, membership corporation, obtained substantially all of the funds necessary to carry on the operation of its divisions by dues from its members, paid for one year in advance.

16. Under the method of accounting employed by plaintiff during the years in issue, prepaid dues collected from members of its divisions were not regarded entirely as income for accounting purposes in the calender year of receipt, but instead prepaid dues were recognized and treated as income ratably over the 12-month membership period whether or not such period extended beyond the close of plaintiff's taxable year.

As of December 31 of each taxable year, the proportion of dues collected within the year which was applicable under plaintiff's system of accounting to memberships extending beyond the close of the taxable year was considered and recorded as a liability of plaintiff and was reflected on plaintiff's balance sheet with its tax return as a liability.

[fol. 77] Expenses which plaintiff considered to fall within the category of prepaid membership costs, e.g., salesmen's commissions, and the cost of accident insurance covering the period of a membership, even though paid by plaintiff, were not deducted entirely in the taxable year paid or incurred, but instead were deducted ratably over the same periods of time that dues were recognized as income.

17. During the calendar years 1953 and 1954, plaintiff recorded on its books and records, by months, the following

amounts of prepaid dues collected from members of its divisions:

	1953	1954
January	$257,698.02	$290,764.23
February	236,610.67	284,319.95
March	282,430.08	351,697.47
April	296,647.02	329,066.99
May	328,191.75	382,385.38
June	378,716.30	451,260.81
July	386,150.87	435,832.93
August	336,269.66	395,009.70
September	275,235.54	260,950.54
October	268,661.48	309,543.51
November	219,278.02	279,144.44
December	265,289.26	308,553.22
	3,531,178.67	4,078,529.17

This money was deposited in plaintiff's bank accounts with no restrictions as to its use for any of its corporate purposes.

Section 4 of the bylaws of the American Automobile Association specifically provided for the use of funds and reads as follows:

> SECTION 4. *(Use of Funds)* This corporation shall use its funds only to accomplish the objects and purposes specified in Section 3, and no part of said funds shall inure, or be distributed, to the members of this corporation. On dissolution the funds of the corporation shall be distributed to one or more regularly organized charitable organizations to be selected by the Board of Directors.

18. Under the accounting system employed by the plaintiff from 1931 through 1953 prepaid dues collected from members who joined in the month of January were recognized as income in January to the extent of 1/24 of such collections, on the assumption that the average or mean date would be the middle of the month. Thereafter, [fol. 78] 1/12 of prepaid collections for January was trans-

ferred or allocated to income for each of the following 11 months, and 1/24 of January collections remained a liability on December 31 and was transferred and recognized as income for January of the following year.

Prepaid dues for each month of the calendar year were treated in the same manner, that is, 1/24 of such collections was transferred and recognized as income in the current month when collections were made, 1/12 of such collections during the following 11 months and 1/24 thereof in the last month when membership expired. The monthly collections of prepaid dues during a calendar year which were recognized and transferred to income during the current year and the portion thereof remaining in the liability account at the end of the year, which was entitled DEFERRED REVENUE MEMBERSHIP DUES, UNEARNED AND DEFERRED INCOME or some similar title, appear in the following tabulation:

	Portion Treated as Income for the Current Year	Portion Remaining in the Liability Account Dec. 31 and Treated as Income the Following Year
January	23/24	1/24
February	21/24	3/24
March	19/24	5/24
April	17/24	7/24
May	15/24	9/24
June	13/24	11/24
July	11/24	13/24
August	9/24	15/24
September	7/24	17/24
October	5/24	19/24
November	3/24	21/24
December	1/24	23/24

The allocation of prepaid dues each month facilitated the preparation of monthly statements of income and expenses. Had monthly collections been equal for each month during a year, the amount recognized as income during the current year and the amount remaining as a liability at the end of the year would have been equal under the foregoing apportionments.

19. Under the method of accounting employed by plaintiff, the proportion existing between dues collected from members of its divisions within a calendar year, which dues [fol. 79] were recognized as income during such year, and the proportion of such dues regarded as a liability at the end of such year was as follows for the calendar years 1949 through 1954:

	Portion Recognized as Income During the Year Collected	Portion Remaining in the Liability Account Dec. 31 and Treated as Income the Following Year
1949	49.9%	50.1%
1950	50.0%	50.0%
1951	50.2%	49.8%
1952	50.6%	49.4%
1953	50.3%	49.7%
1954	50.0%	50.0%

20. Commencing in 1954, in order to simplify much internal detail, the plaintiff changed its procedure in the monthly accounting for prepaid dues by the assignment of 50 percent to income for the current year and 50 percent as a liability which matured as income for the following year.

Plaintiff also adjusted certain inconsistencies in its prepaid expense account in 1954. Some division managers were paid a straight salary, whereas others were paid a nominal salary plus incentive commissions based upon the number of members within the division. These incentive commissions had been previously charged to the prepaid expense account and prorated over membership periods, whereas such incentive pay was actually a part of the manager's compensation. It was treated as current expense in 1954 and thereafter. Also, guaranteed commissions to new salesmen for a certain limited period had been included with commissions earned on subscriptions obtained, as prepaid expense, and beginning in 1954 such unearned guaranteed payments were charged to current expenses.

The plaintiff continued the apportionment of prepaid dues collected and prepaid expenses for commissions and insurance over the period of membership as it had done previously. The basic method of accounting employed by

plaintiff in 1954 was consistent with that employed by plaintiff in 1953 and prior years.

21. The income reported by plaintiff in its tax return for the calendar year 1953 attributable to dues received from members of its divisions was $3,337,813.44, representing $1,562,042.23 of prepaid dues collected in 1952 but not recog- [fol. 80] nized as income until 1953, plus $1,775,771.21 of dues collected in 1953 and recognized as income in that year.

For 1954, dues reported by plaintiff as income for purposes of the Federal income tax totaled $3,794,672.20, representing $1,755,407.46 of advance dues collected in 1953 but not recognized as income until 1954, plus $2,039,264.74 of dues collected in 1954 and recognized as income in that year.

22. The method of accounting employed by plaintiff during the years in issue has been used regularly by plaintiff since 1931 and is in accord with generally accepted commercial accounting principles and practices and was, prior to the adverse determination by the Commissioner of the Internal Revenue, customarily and generally employed in the motor club field.[7]

The Internal Revenue Service did not question the method of accounting employed by plaintiff in computing its net income until the calendar year 1954, at which time deficiencies were proposed for the calendar years 1950, 1951 and 1952, but plaintiff was not required to pay those deficiencies by reason of a compromise settlement.

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[7] Defendant offered no testimony. Plaintiff's testimony consisted of that of its staff auditors supplemented by outstanding certified public accountants testifying as experts who were, also, either familiar with plaintiff's problem or had some direct association with it and whose qualifications were not challenged. They were: *Dr. Wm. A. Paton*, for 44 years a professor of accounting and economics at the University of Michigan and an author and consultant on accounting. *George E. Baker*, Washington, D.C., resident partner of Ernst and Ernst, Certified Public Accountants. *Herbert T. McAuly*, a general and managing partner of Ernst and Ernst. *S. Alexander Bell*, partner in Peat, Marwick, Mitchell & Co., largest firm of Certified Public Accountants in the world.

23. The determination of additional income by the Commissioner of the Internal Revenue Service for the taxable years involved herein was made by including as income the advance payment of dues covering membership benefit periods in the following year and excluding those payments received in the prior year that covered membership benefit periods in the current year.

By taking into income for the current year the amount which plaintiff treated as a liability for servicing membership periods in the following year, the amount of such receipts would be reflected in the plaintiff's surplus account at the end of the current year. The plaintiff's balance sheet as of December 31, 1953, filed with its tax returns for 1953 [fol. 81] and 1954 reflecting the items involved, is compared with the balance sheet which would result from the adjustments by the Commissioner of the Internal Revenue Service in the following table:

	Balance Sheet on December 31, 1953	
	(a) Reported by Plaintiff	(b) Reflecting the Adjustments by the Commissioner of IRS
ASSETS:		
Cash	$1,941,723.88	$1,941,723.88
Prepaid membership cost	398,482.36	.....
Prepaid commissions	177,079.51	177,079.51
All other accounts, net	2,834,525.72	2,834,525.72
Total assets	5,351,811.47	4,953,329.11
LIABILITIES:		
Unearned and deferred income	1,756,485.46	.....
All other liabilities	1,063,462.99	1,063,462.99
Total liabilities	2,819,948.45	1,063,462.99
SURPLUS	2,531,863.02	3,889,866.12

24. The defendant contends that the sole issue is whether the Commissioner of Internal Revenue erred in refusing to allow plaintiff to defer a portion of income actually re-

ceived, without any restriction as to its use, from the year in which it was received to the following year when services might have to be performed under the membership contracts.

The plaintiff's gross income from dues was measured by collection for the period memberships were in effect during the current year. This included pro rata amounts of prepaid dues collected in the prior year covering membership periods that extended into the current year, but excluded prepaid dues collected in the current year for membership periods that extended into the following year. The membership service costs and other operating expenses paid or incurred during the current year were then deducted from such gross income for its determination of net income.

25. Restrictions on the use of funds represented by prepaid dues were not required or intended by the plaintiff's members. On the contrary, the receipt of prepaid dues from members constituted the principal source of plaintiff's operating funds as heretofore found. Funds from other sources, [fol. 82] such as sales of publications, materials and supplies, advertising, etc., were normally received only after the costs and expenses were incurred in producing such revenues.

There is no evidence that membership contracts, or certificates issued by plaintiff to its members, provided any restriction in the use of funds received by plaintiff for dues paid in advance. Plaintiff's financial responsibility is not questioned.

26. The plaintiff prepared and submitted tabulations of the aggregate costs incurred by all of its divisions in servicing all members thereof for each month of each year from 1948 through 1954. These tabulations were received as plaintiff's exhibits 2 through 7, inclusive.

Had the plaintiff recognized, assigned and transferred to its gross income account its monthly receipts of dues collected in advance in the proportion to its cost of servicing all of its members each month, instead of ratably over the membership period of 12 months, the proportion of advance dues which would have been recognized and assigned to gross income during the years in issue herein would have

been substantially the same as the gross income from dues as determined and reported by the plaintiff under the method of accounting actually employed.

27. The proportions of prepaid dues transferred and assigned to gross income by the plaintiff on a pro rata monthly time basis are compared with the proportion of assignments under the average monthly cost bases for servicing memberships in the following table:

	Plaintiff's Pro Rata Method as Reported	Average Monthly Costs for Current Year	Average Monthly Costs over Prior 5-year Period
1953			
Apportioned to Gross Income during current year	50.3%	49.8%	50.4%
Deferred to the Following Year (reported as a liability at the end of the current year)	49.7%	50.2%	49.6%
1954			
Apportioned to Gross Income during the current year	50.0%	48.8%	51.0%
Deferred to the following year (reported as a liability at the end of the current year)	50.0%	51.2%	49.0%

[fol. 83] 28. The recognition, assignment and transfer of dues collected in advance to gross income on the basis of actual costs of servicing members is feasible under the accrual method of accounting, particularly in testing the results of prorating such collections on a time basis. It is not as practicable as the assignment of prepaid dues on a pro rata monthly basis because the current costs incurred must first be determined. The employment of a prior year's monthly costs or a composite of monthly costs for five prior years might not be as accurate as the method actually employed by plaintiff because of a constant increase in membership reflected over the years or by

abnormal costs of servicing members during one or more of such prior years.

When members paid their annual membership dues they became entitled to membership services over a period of 12 months, notwithstanding any variations in costs to the plaintiff in furnishing the services that might be required.

29. The plaintiff's membership for all divisions reflects a constant increase from month to month during 1953 and 1954. The minimum number of memberships in effect in 1953 was 220,435 in January and the maximum was 246,856 in December of that year. The minimum number of memberships in effect in 1954 was 249,805 in January and the maximum was 295,889 in December of that year. The average cost to plaintiff of servicing a member during the calendar year 1953 was $14.50 and the average cost for 1954 was $14.72.

30. The plaintiff's costs for servicing members were substantially in proportion to membership from year to year with reasonable constancy from month to month. The plaintiff's actual costs of servicing all members from 1948 to 1954 are set out in the following tabulation:

1948	$1,587,794.87
1949	1,698,144.27
1950	2,012,466.23
1951	2,614,396.96
1952	3,109,068.21
1953	3,377,389.91
1954	3,991,068.00

31. The actual average monthly cost per membership in effect during 1953 and 1954 and the percentage of the total [fol. 84] annual cost per member is reported in the following tabulation, with the percentage of the total monthly costs to the total costs for the preceding five-year period:

Month	1953 Average monthly cost per member: Amount	1953 Average monthly cost per member: Percent of cost for year	1953 Percent of monthly costs to total over prior 5-year period	1954 Average monthly cost per member: Amount	1954 Average monthly cost per member: Percent of cost for year	1954 Percent of monthly costs to total over prior 5-year period
January	$1.12	7.71	7.48	$1.12	7.62	7.46
February	1.10	7.57	7.47	1.27	8.62	7.34
March	1.24	8.52	8.54	1.37	9.27	8.44
April	1.32	9.15	8.83	1.24	8.41	8.82
May	1.28	8.84	8.97	1.35	9.18	8.83
June	1.32	9.12	9.03	1.41	9.56	9.07
July	1.35	9.28	8.90	1.34	9.12	8.93
August	1.23	8.52	8.58	1.24	8.41	8.67
September	1.19	8.22	8.15	1.20	8.16	8.26
October	1.19	8.19	8.20	1.17	7.95	8.42
November	1.06	7.29	7.56	1.10	7.49	7.65
December	1.10	7.59	8.29	.91	6.21	8.11
Total	14.50	100.00	100.00	14.72	100.00	100.00

The foregoing tabulation reflects the actual average cost to plaintiff in each month of the years involved for each member whose membership continued in effect. The difference between the costs incurred for servicing memberships that continued from the prior year and the membership fees collected in the prior year, but treated by plaintiff as a liability of the plaintiff at the end of the year and transferred to gross income in the current year, would, under plaintiff's system of accounting, represent the net income in the current year applicable to such memberships.

Conclusion of Law

Upon the foregoing findings of fact, which are made a part of the judgment herein, the court concludes as a matter of law that plaintiff is not entitled to recover, and its petition is therefore dismissed.

[fol. 85]

IN THE UNITED STATES COURT OF CLAIMS.

[Title omitted]

MOTION FOR REHEARING AND FOR AMENDMENT OF FINDINGS OF FACT AND CONCLUSIONS OF LAW—Filed March 25, 1960

Comes now the plaintiff in the above described case and moves that this Court (1) grant a rehearing (2) amend its Findings of Fact and (3) alter its judgment for the reasons described below:.

1. The Court has stricken from its Findings of Fact a number of vitally important facts which were established by plaintiff's uncontradicted testimony and which were included in the Findings of Fact made by Commissioner Bennett who heard the testimony in the case, all of which Findings of Fact plaintiff respectfully requests this Court to restore.

2. The Court's present opinion is inconsistent with its Findings of Fact in that the opinion holds the plaintiff's method of deferral is "purely artificial" whereas Finding of Fact (22) states that plaintiff's method of deferral is in accordance with generally accepted accounting practices. This inconsistency becomes even more apparent if Com-
[fol. 86] missioner Bennett's Findings of Fact are restored. The Court's judgment should be altered to conform to the facts.

3. The decision in the case at bar is an improper extension of the decision of the United States Supreme Court in *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180, because plaintiff in the case at bar proved that its method of deferral was in accordance with generally accepted accounting practices which plaintiff in the *Michigan Club* case failed to do.

4. The Internal Revenue Code and Treasury Regulations do not permit the Commissioner of Internal Revenue to disturb a taxpayer's method of accounting if it is in accordance with generally accepted accounting practices. A

realistic deferral of income is permissible under the statutes, regulations and applicable Court decisions, and plaintiff has proved its method of accounting for prepaid dues income is both realistic and practical.

A brief in support of this motion is attached hereto and made a part hereof.

Wherefore plaintiff respectfully requests that a rehearing be granted in order that the Court's Findings of Fact may be amended and corrected, and that its judgment may be altered.

Respectfully submitted,

Fleming Bomar, Joseph E. McAndrews, Attorneys for Plaintiff, 306 Southern Building, Washington, D. C.

Of Counsel: Ivins, Phillips & Barker, Washington, D. C.

[fol. 87]

BRIEF IN SUPPORT OF MOTION FOR REHEARING

1. Plaintiff requests the restoration of the Findings of Fact as made by Commissioner Bennett.

The decision of the Court in the case at bar was based upon the ground that the issue had already been decided by the United States Supreme Court in *Automobile Club of Michigan* v. *Commissioner,* 353 U.S. 180. It becomes exceedingly important, therefore, to have an accurate comparison between the facts established in the *Michigan* case and the facts established in the case at bar. Plaintiff therefore respectfully requests this Court to restore the Findings of Fact made by Commissioner Bennett who heard the testimony in the case, who had the opportunity of seeing and evaluating the expert accountants produced by plaintiff, and who determined that his Findings of Fact were "supported by the overwhelming weight of documentary evidence and expert testimony". Specifically, plaintiff

requests that the Findings of Fact made in the Report of [fol. 88] Commissioner Bennett filed July 16, 1959 be restored in their entirety and particularly in the following respects:

(a) With respect to the accounting principle which is in issue, Commissioner Bennett found, in Paragraph 23 of his Report, the following fact:

> "23. Under generally accepted accounting principles a distinction is made between a financing transaction and a revenue or income transaction. Funds received in a revenue or income transaction are reflected in the profit and loss statement of a taxpayer as gross income. This is not true in the case of funds received in a financing transaction. They are reflected in the balance sheet as liabilities.
>
> "Financing transactions involve ways and means of raising funds for business operations and may be grouped under three general types: (a) funds obtained from shareholders in exchange for stock; (b) funds obtained from banks or other lenders on notes, bonds or other evidence of indebtedness; and (c) funds obtained by advances from customers or members on open accounts, receipts or certificates of membership for future delivery of goods or services to be rendered in the future.
>
> "Funds representing advances from customers or members of an organization are not income at the time they are received but constitute a liability until such time as goods are delivered or services are rendered or made available in accordance with the advance payment agreement. It is an undisputed principle of accounting that no revenue or income can emerge until goods are delivered or until services are rendered.
>
> "Upon the prepayment of annual dues a member of the plaintiff corporation acquired a right to receive certain materials, information and services provided in the membership agreement over a 12-month period. Plaintiff's liability to such member cannot be completely discharged until the expiration of the membership period. Under generally accepted accounting

[fol. 89] principles, it is realistic and reasonable to recognize and transfer to gross income such prepaid dues ratably over the period of membership." [Paragraph 23].

(b) And with respect to the so-called method of accounting which the Commissioner of Internal Revenue forced upon plaintiff, Commissioner Bennett found as a fact that:

(1) " . . . This application of the receipt of funds as income is contrary to generally accepted accounting principles and practices." [Paragraph 24].

(2) " . . . the adjustments by the Commissioner of the Internal Revenue Service, reflects an overstatement of surplus for 1953 of $1,358,003.10, or approximately 54% in excess of the true surplus." [Paragraph 24].

(3) "By applying similar adjustments to plaintiff's balance sheet as of December 31, 1954, the surplus would be increased and overstated by $1,634,840.81, or approximately 99 percent, and would omit plaintiff's liability to members for a similar amount." [Paragraph 24].

(4) "The evidence establishes that reputable members of the accounting profession would not certify to the accuracy of the income statements and the balance sheets reflecting the adjustments by the Commissioner of the Internal Revenue Service." [Paragraph 24].

(c) With respect to the realistic and practical nature of the method of accounting used by plaintiff consistently since 1931, Commissioner Bennett found as a fact:

"The advance payment on a service contract, or any other type of contract, does not constitute income or revenue to the recipient, although the acceptance thereof creates a liability to perform. Under generally accepted accounting principles, the accounting for the funds received in advance must be recorded as a liability of the recipient. The plaintiff did this con-

sistently since 1931. These membership contracts entitled the members to receive membership services over [fol. 90] a period of 12 months from the date of subscription and acceptance. . . .

"The method of accounting employed by plaintiff was in accordance with accepted accounting principles. The assignment and transfer of funds from the prepaid dues account to revenue or gross income measured over the period of the membership contracts is found to be the most realistic method for properly recording gross income from dues." [Paragraph 25].

"On the evidence presented, the recognition and assignment of prepaid dues ratably over the period of membership is found to be the most realistic and practical method of accounting for gross income from membership dues." [Paragraph 29].

"The plaintiff's liability for servicing members whose membership continued beyond the current year when dues were paid was not a 'contingent' liability. It was a true liability and the costs were substantially in proportion to membership from year to year with reasonable constancy from month to month. . . . " [Paragraph 31].

(d) And in conclusion Commissioner Bennett made the following crucial Finding of Fact which plaintiff respectfully requests this Court to restore.

"33. The plaintiff's liability to members for that portion of their memberships which extended beyond the current year in which plaintiff collected the dues in advance is not gross income from membership dues because it was paid and received for a later year. Neither can it be net income in the year when the dues were received because the cost of servicing such memberships could not be performed until the following year when such net income would be realized.

"The method of accounting employed by the plaintiff during the calendar years 1953 and 1954 and prior years in keeping its books and records clearly reflected its net income for such years. The plaintiff's income

tax returns for 1953 and 1954 were prepared in accordance with the method of accounting employed in keep-
[fol. 91] ing its books and records and clearly reflected the net income for these years. This conclusion and the findings set forth above are supported by the overwhelming weight of the documentary evidence and expert testimony." [Paragraph 33].

(e) This Court in its Findings of Fact, in Paragraph 22, stated:

"22. The method of accounting employed by plaintiff during the years in issue has been used regularly by plaintiff since 1931 and is in accord with generally accepted commercial accounting principles and practices and was, prior to the adverse determination by the Commissioner of the Internal Revenue, customarily and generally employed in the motor club field."

Plaintiff respectfully requests this Court to strike the word "commercial" from the above described Finding of Fact and to strike out the phrase "and was, prior to the adverse determination by the Commissioner of the Internal Revenue, customarily and generally employed in the motor club field." There is no reference whatsoever in the record to commercial accounting principles as contrasted with generally accepted accounting principles. There is no reference in the record to the fact that any motor club, much less plaintiff, does not continue to keep its books and records in accordance with the only method of accounting which clearly reflects its income regardless of the position taken by the Commissioner of Internal Revenue.

2. The Court's present opinion is inconsistent with its Findings of Fact, and should be altered to conform to its Findings of Fact.

The Court has stated on page four of its opinion:

"The issue to be decided by this court is whether the Commissioner of Internal Revenue correctly determined that plaintiff's method of accounting—with respect to dues received from members of its divisions

> —does not clearly reflect plaintiff's income within the [fol. 92] meaning of §41 of the Internal Revenue Code of 1939 and §446 of the Internal Revenue Code of 1954."

On page five of its opinion the Court infers that the basis of its decision was that plaintiff's method of accounting is "purely artificial." However, the Court also states, on page six of its opinion, that the *Michigan Club* case did not expressly rule out deferral of income; and in its Finding of Fact (22) the Court states that the method of accounting used by plaintiff regularly since 1931 is in accord with generally accepted commercial accounting principles and practices and has been customarily employed in the motor club industry. These Findings of Fact and conclusions are wholly inconsistent. Commissioner Bennett's Findings of Fact which plaintiff has requested this Court to restore make this point even more clearly. Findings of Fact (26), (30) and (31) as made by this Court further show that the method of deferral employed by plaintiff was realistic since advance dues were reported as income over the same period of time that the costs of servicing members were incurred. Since the Court has found that the plaintiff's method of deferral is in accord with generally accepted commercial accounting principles, it would follow that if any system of deferral is allowable it would be the system used by plaintiff. By disallowing the use of plaintiff's method of deferral the Court is in effect holding that no method of deferral is permissible for motor clubs—an unwarranted extension of the doctrine of the *Michigan Club* case.

Since the Court has found as a fact that plaintiff's method of accounting is in accord with generally accepted accounting principles and since the sole purpose of accounting principles is to reflect income clearly, it is most inconsistent for the Court to conclude that plaintiff's method of accounting is "purely artificial." This is particularly true in view of the fact that neither the Commissioner of Internal Revenue nor the Court has suggested any method [fol. 93] of deferral although deferral is essential in order to reflect plaintiff's income accurately.

Accordingly the Court's opinion should be altered to remove the inconsistency which exists therein.

3. The decision of the Court of Claims in the case at bar represents an unwarranted extension of the decision of the United States Supreme Court in Automobile Club of Michigan v. United States.

In the *Michigan* case the method of accounting employed by the taxpayer was described by the Supreme Court as "artificial" and was held not to clearly reflect income for the reason, presumably, that the pro rata allocation of dues over the period of a membership "bears no relation to the services which petitioner may in fact be called upon to render for the member." 353 U.S. 180, at 189. In the *Michigan* case there was no accounting testimony of any kind, expert or otherwise. There was not even an adequate explanation of the method of accounting used by the Michigan Club. There was no proof of any relationship between the period of time over which advance dues of members were recognized as income and the period of time over which the costs of serving its members were incurred. There was no testimony to the effect that the Government's method of accounting was not in accord with generally accepted accounting principles and did not reflect accurately the income of the Michigan Club. The trial and appellate courts were left to speculate about these matters.

By contrast, in the case at bar there was uncontradicted and unassailable proof of the fact:

(a) That taxpayer's method of accounting was in accord with generally accepted accounting principles.

(b) That there was a precise and constant correlation between the period of time over which advance dues were recognized as income and the period of time over which [fol. 94] costs were incurred in serving its members—in other words, there was an almost exact matching of income and expense, which is the essence of accrual accounting.

(c) That the taxpayer's method of accounting with respect to prepaid dues income was realistic and was the most practical method of accounting which it could have employed.

(d) That the taxpayer's method of accounting clearly reflected its net income.

(e) That the Government's method of accounting is not in accord with generally accepted accounting principles and practices.

(f) That the Government's method of accounting results in an overstatement of plaintiff's surplus account of $1,358,003.10 in 1953, and an overstatement of surplus of $1,634,840.81 in 1954.

(g) That the Government's method of accounting for prepaid dues income does not reflect taxpayer's net income accurately.

(h) That no reputable certified public accountant would certify to the accuracy of plaintiff's profit and loss statements or balance sheets if the Government's method of accounting for prepaid dues is forced upon plaintiff.

This Court is therefore clearly extending the *Michigan* decision if it holds that the Commissioner of Internal Revenue has not exceeded the permissible limits of his discretionary authority when he changes the method of accounting of a taxpayer from one which reflects its net income clearly to one which does not.

4. A realistic deferral of income is permissible under the statutes, regulations and court decisions.

In its opinion in the case at bar the Court of Claims stated:

> [fol. 95] "... it would appear that Automobile Club of Michigan does not expressly rule out deferral of income...."

The United States Court of Appeals for the Second Circuit in *Bressner Radio, Inc.* v. *Commissioner*, 267 F. (2d) 526, which was decided after the *Michigan Club* case, stated this conclusion as follows:

> "It is apparent from the decision of the majority [in the Michigan case] that at least for purposes of the decision of the case it assumed that a realistic deferral

would have been permissible, and found only that no realistic deferral was made."

The statutory provision permitting a realistic deferral is Section 42 of the 1939 Code and Section 451 of the 1954 Code, both of which state:

> "The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, *unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.*" (Emphasis supplied.)

The above quoted statute which this Court does not mention in its opinion is the sole authority for the Regulations issued by the Internal Revenue Service with respect to "long term building, installation or construction contracts." Regs. 1.451-3. If a builder receives a $25,000 advance payment in connection with a contract that extends beyond twelve months, the builder is not required to report the $25,000 as income until the contract is completed—if the completed contract method of accounting is elected—or pro rata as the building progresses, if the percentage of completion method of accounting is used.

Under the authority of the same statute the Commissioner of Internal Revenue, long before the *Beacon Publishing Company* case (218 F. (2d) 697), ruled that pub- [fol. 96] lishers could defer until the year of delivery prepaid subscription income. I.T. 3369, 1940-1 C.B. 46.

Under the authority of the same statute, the Commissioner of Internal Revenue has ruled that a travel bureau can defer reporting until the year in which the cruise takes place, advance payments made by customers to reserve space on the cruise. I.T. 2080, III-2 C.B. 48.

It would be exceedingly illogical if the same statute did not permit the realistic deferral of prepaid income received in connection with a service contract, or in connection with membership privileges where the costs involved will be incurred necessarily in the future.

How can the tax treatment of prepaid dues be distinguished from the tax treatment of prepaid magazine sub-

scriptions, prepaid income in connection with building, installation and construction contracts and prepaid cruise tickets? The United States Court of Appeals in *Bressner Radio, Inc.* v. *Commissioner, supra* (prepaid television service contracts), says they cannot, and it is respectfully submitted that the Second Circuit is correct. This Court is requested to alter its decision to reach the same result as that reached by the Second Circuit in the *Bressner* case. As a very minimum, this Court should restore the Findings of Fact of Commissioner Bennett so that the conflict between this Court's opinion and that of the Second Circuit will become apparent for purposes of Supreme Court review.

[fol. 97]

CONCLUSION

For the reasons above stated, a rehearing should be granted to give plaintiff an opportunity to present argument that the Court's opinion should be altered or amended.

Respectfully submitted,

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Of Counsel: Ivins, Phillips & Barker, Washington, D. C.

[fol. 98]

IN THE UNITED STATES COURT OF CLAIMS

[Title omitted]

ORDER DENYING MOTION FOR REHEARING AND FOR AMENDMENT OF FINDINGS OF FACT AND CONCLUSIONS OF LAW—May 4, 1960

These cases come before the court on motions for rehearings, amendment of judgments or new trials under Rules 53 or 54 of the Rules of this court and, on consideration thereof,

It Is Ordered this fourth day of May, 1960, that said motions be and the same are overruled as follows:

274-54 New Jersey Automobile Club. Plaintiff's motion.
307-56 Herbert Rosengarten.
308-56 David Rosengarten. Plaintiffs' motion.
454-56 Concetta F. Stamer. Defendant's motion. Third party defendant's motion.
311-58 American Automobile Association. Plaintiff's motion.
356-58 Mary R. Palmer, Administratrix of the Estate of James C. Palmer. Plaintiff's motion.

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411-58 Irving Dulcy. Plaintiff's motion.
429-58 Hugh N. Fleming, Jr. Plaintiff's motion.
548-58 Garrett L. Schuyler. Defendant's motion.
70-59 Sicanoff Vegetable Oil Corp. Plaintiff's motion.

By the Court

Marvin Jones, Chief Judge.

[fol. 100] Clerk's Certificate to foregoing transcript (omitted in printing).

[fol. 101]

SUPREME COURT OF THE UNITED STATES

No. 288, October Term, 1960

AMERICAN AUTOMOBILE ASSOCIATION, Petitioner,

vs.

UNITED STATES

ORDER ALLOWING CERTIORARI—October 10, 1960

The petition herein for a writ of certiorari to the United States Court of Claims is granted, and the case is transferred to the summary calendar.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.